1-1-1990

The critical phase in a business failure-turnaround sequence : a study of the role of commercial banks as an influential trigger in the US and Canada.

C. Gopinath
University of Massachusetts Amherst

THE CRITICAL PHASE IN A BUSINESS FAILURE - TURNAROUND SEQUENCE: A STUDY OF THE ROLE OF COMMERCIAL BANKS AS AN INFLUENTIAL TRIGGER IN THE US AND CANADA

A Dissertation Presented

by

C. GOPINATH

Submitted to the Graduate School of the University of Massachusetts in partial fulfillment of the requirements for the degree of

DOCTOR OF PHILOSOPHY

May 1990

School of Management

THE CRITICAL PHASE IN A BUSINESS FAILURE - TURNAROUND SEQUENCE: A STUDY OF THE ROLE OF COMMERCIAL BANKS AS AN INFLUENTIAL TRIGGER IN THE US AND CANADA

A Dissertation Presented

by

C. GOPINATH

Approved as to style and content by:

A. Elliott Carlisle

A. Elliott Carlisle, Chair

Michael H. Best

Michael H. Best, Member

Dean M. Schroeder

Dean M. Schroeder, Member

Michael R. Sutherland

Michael R. Sutherland, Member

B. Branch

Ben Branch, Director
Ph.D. Program
School of Management

Dedicated to Kamala & (late) T.S.Chintamani,

Kausalya & B.S.Raghavan, whose blessings

I will always cherish.

ACKNOWLEDGEMENTS

I always wanted to pursue a PhD program. In turning that desire into reality, I realize how much I owe to so many who helped to make it possible. While I acknowledge only a few by name, I greatly appreciate many more who helped me in some way or the other in my effort.

I am grateful for the assistance and direction of my dissertation committee. Professor Elliott Carlisle, my Chairman, was a constant source of support and advice, and he gave freely of his time. Professor Dean Schroeder took great interest in my intellectual development and was always ready to help. Professor Michael Best provided an international perspective to my thinking and Professor Michael Sutherland helped me keep the analysis straight and simple. I once again thank them all.

My grateful thanks to the banks and their officers in the US and Canada who participated in the study. I also gratefully acknowledge the assistance of the Institute for North American Trade and Economics, School of Management, University of Massachusetts, for their partial funding of this study and allowing me liberal use of the office facilities. To Professor Carlisle, Professor Liander and Gary Throop of INATE, a special thanks.

Professor Tony Butterfield initially as Director of the program and subsequently as Chairman of the department was sympathetic towards my progress and ready to help. To Bob, Julie, and Steve, for your support and the many hours spent

in discussion (serious and otherwise), thanks. To my other friends Nalini & Easwar, Ruki & Vijay, and many more, you were a big help.

Finally, a big thanks to my family. My brothers, Jakki & Prem, and sisters, Mohana & Usha, were very supportive and I shall always be grateful for that. My wife, Chinni, provided me with a level of material and emotional support that made this venture possible. Her infinite sense of hope and confidence kept me sane. My children, Dasharath and Bharadwaj, participated by providing welcome distractions; without their help, this dissertation may even have been completed earlier!

ABSTRACT

THE CRITICAL PHASE IN A BUSINESS FAILURE-TURNAROUND SEQUENCE: A STUDY OF THE ROLE OF COMMERCIAL BANKS AS AN INFLUENTIAL TRIGGER IN THE US AND CANADA

MAY 1990

C.GOPINATH, B.A., UNIVERSITY OF MADRAS

M.A., UNIVERSITY OF DELHI

P.G.D.B.A., INDIAN INSTITUTE OF MANAGEMENT, AHMEDABAD

Ph.D., UNIVERSITY OF MASSACHUSETTS

Directed by: Professor A. Elliott Carlisle

This is an exploratory study into the role commercial banks play in triggering recognition of failure in a declining firm and the nature of the bank's responses. Management literature has excluded important issues in the critical phase intervening decline and turnaround such as how the recognition of failure takes place, and the possible external influences on the turnaround strategy.

Commercial banks being an influential external agency are ideally placed to perform this role. The study covered four banks in Canada and six banks in the US. The data collection comprised of qualitative sources (27 in-depth interviews with bank officers) and quantitative sources (questionnaire to loan officers seeking information pertaining to specific problem loan firms). Information on 34 cases in the US and 146 in Canada was obtained. The quantitative data was studied using correlational analysis, factor analysis, and a multiple regression model to help explain the bank's response strategies.

The study shows that acting out of self-interest, the banks are a source of triggering early recognition of failure in the firms and attempt to distinguish between decline in performance and impending failure. The variables explaining the response strategy of the bank include: the causes (internal/external) for decline, extent of security coverage, severity of the decline, the extent of cooperation with the bank, size, and the bank's judgement on the ability of the firm to turnaround. The bank's response should be considered at two levels: the initial efforts of the loan officer and the subsequent institutional response of the bank.

While there were only a few major differences between US and Canadian banks on several aspects of recognition and response, they exhibited different correlation structures. While both US and Canadian officers preferred a workout to an exit strategy, the US officers had a bias towards a financial approach including additional financial coverage, and the Canadian officers showed a managerial approach including managerial changes.

From the perspective of strategic management, this study shows the importance of a source outside the firm in triggering recognition of failure and its influence on the turnaround strategy of the firm.

TABLE OF CONTENTS

LIST OF TABLES

LIST OF FIGURES

CHAPTER I

INTRODUCTION

> "Perhaps as a result of the stigma of decline and problems with acquiring resources, or perhaps because this is a relatively new area of scholarly research, people who build and test theories about declining organizations have an array of opportunities to make new contributions".
>
> - Kim Cameron, Robert Sutton, and Dave Whetten (1988, p.16)

Since businesses generally wish to grow and make a profit, issues concerning decline would not be expected to have a continuing and absorbing interest to researchers. Not only do the issues have a negative connotation but they can often be easily dismissed as problems of recession or mismanagement. However, the nature of problems and the repercussions of failure are so severe and drastic that the issues merit specific attention rather than to be looked upon as the absence of success.

The field of business failures and turnaround has now been receiving attention with leading scholars (Whetten, 1980a) highlighting areas for research and its implications. It has been estimated that 75 percent of the academic literature on organizational decline has appeared since 1978 (Cameron, Sutton, and Whetten, 1988). Researchers have been looking at issues connected with the causes of decline and failure, prediction of failure, nature of turnaround strategies and how they should be implemented. A reason for the increase in the interest in this field could be the reality of the competitive business world of today. The

Statistical Abstract of the United States 1989 (which quotes the Dun & Bradstreet data) shows a significant jump in the number of failures per 10,000 concerns since 1981. While this figure had been in the range of 40 during 1968 to 1976, it dropped to below 30 between 1977 and 1979. Since then, it started a steep climb and has been 61, 88, 110, 107, 115, and 120 for the years 1981 to 1986. While the preliminary figure of 102 for 1987 is showing a tendency to taper off, it is still a disturbing trend. This concern has also been reflected in the reports appearing in Business Week, Fortune, etc. about the decline of American competitiveness and in the increasing debate about the causes for it (Lawrence and Dyer, 1983; Piore and Sabel, 1984; Magaziner and Reich, 1982). While the optimists may dismiss all this as the `normal' restructuring in the context of a rapidly changing world and others may call for an industrial policy, for a management scholar, it poses interesting challenges.

The meaning of failure has been defined variously by researchers but for the purposes of this study the primary interest will be on situations wherein the decline in the performance of the firm is beginning to threaten its survival. Turnaround strategy is the name given to the efforts directed at reviving a failing enterprise. It therefore presupposes that the firm is failing, has the potential for recovery and that there is a body of persons who are charged with the responsibility for turnaround.

This study was undertaken to explore a set of issues which have been either ignored or not given due importance in the literature. It specifically focuses on the questions of recognition of decline and failure, and the responses to it. Moving away from the notion of supremacy of management, a model is introduced to suggest the high probability of an external agency making this recognition, viz. the commercial bank. The influence of the bank on the strategy of the failing firm is seen through its responses. In order to examine the process of recognition of decline and failure and the responses under different environmental settings, banks in Canada and in the United States were chosen for study.

The report begins (Chapter II) with a discussion of the relevant aspects of the literature pertaining to decline and turnaround. The review covers the causes and process of decline, definitions of decline and failure, the problem of recognition, management change issues, and an overview of turnaround strategies. This review of the prevailing state of the knowledge helps to identify gaps in our understanding which this study seeks to fill. Chapter III develops the idea further by looking for a theoretical explanation to the questions posed and describes a framework focusing on external sources of recognition as a setting for this study. In Chapter IV, there is a discussion of the research methodology adopted. Due to the exploratory nature of the study, a combination of quantitative (through questionnaires) and qualitative (through interviews) methods of data collection was used to study banks as institutions recognizing a problem loan and loan officers responding to specific problem loan clients.

The outcome of the study is described in Chapter V as a set of observations supported by relevant data and analysis. The issues covered include the distinction in the severity of the problem loan, the process of recognition of a problem loan by the bank, the role of the loan officer vis a vis that of the bank, the array of responses used by the bank and the factors influencing each response strategy. The study shows that banks do attempt an early recognition of the problem and distinguish between levels of severity of the problem in their responses to it. In responding to the problem loan through various measures, they attempt to influence the turnaround strategy of the firm. Chapter VI provides a summary and the main conclusions of the study, discusses the limitations, and draws out implications for research and for managers.

CHAPTER II

LITERATURE REVIEW

> "The literature on the management of growth and decline is the least well developed....our knowledge of the antecedents and outcomes of growth far surpasses our understanding of organizational decline."
>
> - Dave Whetten (1987, p.354)

The conventional view of research into the sequence of decline and turnaround has been to look at the causes of decline and thereby discern turnaround strategies. The objective in studying causes of decline is to draw lessons from the experiences of others and to identify the means for reversing downward trends.

A. Causes of Decline

Causes of decline are usually looked at broadly as being due to strategic reasons (external, improper fit with the environment), and operating reasons (internal, inefficiencies in operation). An early distinction between the two was made by Schendel, Patton, and Riggs (1976). They concluded that declines are ultimately caused by inefficient conduct of an otherwise suitable strategy or a strategy no longer well adapted to the environment. Some authors concentrate on strategic issues alone (Gilad, Kaish, and Loeb, 1985; Richards, 1973) while others focus more on operational causes of decline (Bibeault, 1982; Dolan, 1983; Ross & Kami, 1973), or financial reasons (Platt, 1985) to explain failure. Looking at the internal organizational factors precipitating decline in large established corporations, Lorange & Nelson (1987) note that success often triggers decline by encouraging complacency. Miller (1977) and Miller & Friesen (1977) using data from published case studies arrived at successful and failure archetypes of strategy formulation. In discussing the failure archetypes, they argue that causes of failures often originate from within the company, from intrinsically interrelated factors frequently rooted in the behavior of managers such as decision making styles, delegation of authority, etc. Many other writers on turnarounds have noted that the nature of the strategy followed is closely related to the causes of decline (Bibeault, 1982; Dolan, 1983; Hambrick & Schecter, 1983; Hofer, 1980; O'Neill, 1986; Schendel et al., 1976; Whetten, 1980). They opine that operational causes for decline are usually tackled by operating improvements and strategic reasons for failure with strategic turnarounds.

The theme of these writings is to suggest that once the causes of failure are identified then a turnaround strategy tackling the causes can be initiated.

B. The Process of Decline

In addition to identifying the causes which lead to failure, it is important to understand the process of decline and thereby the timing for the institution of turnaround strategies. The earlier the problems are identified, the sooner can corrective action be initiated (Slatter, 1984), the greater the chances of success.

Some scholars who have studied the decline process have distinguished between phases in the decline. An early attempt at describing the stages of decline was made by Argenti (1976b). He described three broad types or trajectories which would explain the vast majority of failures that occur; each following a different sequence marked by different combinations of causes and symptoms. Plotting the general health of the company over time, Type 1 would apply to small and start-up firms who remain at a low level of health before collapsing, Type 2 also applying to young firms who though alive longer, go through a burst of improved health before failing, and Type 3 applicable to established firms who experience a decline, then linger for a while at a low level of performance before collapsing. The objective of identifying these stages was to help an organization to recognize that they were following a pattern and take corrective action.

Hambrick and D'Aveni (1988) undertook an empirical study of 57 large bankruptcies gathered from secondary sources and found that weakness in these firms showed up early and there is a substantial period of warning before failure. Their research has shown that failing firms follow different longitudinal patterns of decline before failing and some decline and linger in a state of strategic paralysis for many years. They found support for the failure typologies proposed by Argenti.

Weitzel and Jonsson (1989) looked at decline in a conceptual framework as occurring by degrees and presented a detailed description of the stages of decline. In the first stage of decline, called the `blinded stage', negative pressures do not yet manifest themselves in financial reports. In the second stage, the `inaction stage', the signs include sliding profits, declining sales, and increasing inventories. However, there may not be any certainty as to whether the causes are only of a temporary nature or more long term. In the third stage, the `faulty action stage', overt indicators multiply but the causes are not tackled. This leads to the `crisis stage' when the organization must undergo major revitalization or suffer failure. The last stage of decline, the `dissolution stage', is irreversible.

These authors have established the importance of studying the trajectories of decline. It could be rapid or gradual, and an organization could linger at a subsistence level for a long time without actually failing. Different symptoms are revealed at different stages before the organization ultimately collapses.

C. Decline versus Failure

It is important at this point to distinguish between the terms decline and failure. Definitions in this field are still an unsettled issue. Researchers undertaking empirical studies have operationalized it in many ways. Using Bibeault's (1982) framework, they can be examined as falling under economic, legal, and managerial perspectives.

1. Economic

If the rate of return on invested capital is significantly and consistently lower than prevailing rates on similar investments (Altman, 1983; Bibeault, 1982), it would be considered a failure in the economic sense. Using the GNP as a benchmark, Schendel et al.(1976) defined decline as 4 years of uninterrupted decline in net income normalized by GNP growth, i.e. if growth in net income were less than the growth in GNP, then it is a decline. Ramanujam (1984) also used a similar definition but for the substitution of ROI for net income. Conceptually, it is difficult to accept that an organization is in decline just because it is growing slower than GNP. The GNP is influenced by factors other than industrial growth and different industries grow at different rates. Moreover, as it is often mentioned in the case of Japan, a firm may consciously sacrifice short-term profits in favor of long-term interests. It would be an error to classify them as being in decline. In O'Neill's (1980) study of the commercial banking industry, where an individual bank's rate of growth in net income is less than that of the industry, its performance for that year is recorded as decline. This definition is more realistic as it is confined to a performance measure of a specific industry rather than being related to a broader notion of GNP. However, looking at rate of growth of income or profits in relation to national or industry average would still mean that at any point of time half the number would be in decline. This would not necessarily reflect on the individual performance of the firm in question.

2. Legal

Taking a legal point of view, some scholars have defined failure as occurring when an organization files for bankruptcy (Chaganti, Mahajan & Sharma, 1985; Hambrick & D'Aveni, 1988; Schwartz & Mennon, 1985; Sharma & Mahajan, 1980). Platt (1985) makes a technical distinction between insolvency when a firm's liabilities excluding equity capital exceeds total assets, and bankruptcy which is a legal recognition that an individual or company is insolvent. Bruno, Leidecker, & Harder (1987) stop short of the legal requirement of bankruptcy and follow the definition of Dun & Bradstreet (1981) by considering those organizations which have ceased operations with loss to creditors. This may or may not include filing for bankruptcy.

3. Managerial

From a managerial standpoint, Bibeault argues that any decline in performance can be considered to be a business failure. Any stagnation or declining profitability results in pressures on management to reverse the trend. He operationalizes this in his study to include firms which had declined to the point of sustaining losses in net income or had severe earnings decline of 80 percent or more. Miller (1977) considers failure as protracted periods of poor profits and eroding market share but not necessarily bankruptcy.

An examination of these various definitions indicates that there appears to be a confusion between the terms decline, failure, and bankruptcy and the conceptual and operational forms of the definition. Firms could experience a fall in performance and turnaround without being in a crisis, and others could continue in that state of decline for a long time until a crisis (Schendel & Patton, 1976). Whereas the term decline could represent a temporary or preliminary condition, failure has a finality to it that is more drastic. Bankruptcy, with its precise legal definition, is certainly a narrower concept than business failure, since the latter does not necessarily involve bankruptcy proceedings. Again, filing for bankruptcy does not always mean business failure and could be just a means for reorganization. (The requirements under the bankruptcy law changed in 1978 wherein there is no need to prove insolvency for filing under Chapter 11 for reorganization.) Creditors do reach agreements with debtors without going through the bankruptcy process. Discontinued businesses would also include closures of various kinds apart from failure, such as retirement, illness of the proprietor, etc. Moreover, as LoPucki (1983) points out, by the time a firm has come to the stage of filing for bankruptcy, the problems have worsened considerably, the seriousness is obvious to all and the firm is essentially seeking protection.

Argenti (1976b) distinguishes between collapse (`when a company, which has hitherto been operating successfully, first begins to falter and then has to fight to remain profitable... the transformation from corporate health and prosperity to a struggle for survival' p.5), and failure (`a company whose performance is so poor that sooner or later it is bound to have to call in the receiver or cease to trade or go into voluntary liquidation, or which is about to do any of these or has already done so' p.6). The term `failure' has been used (Pfeffer and Salancik, 1978) to denote total ineffectiveness due to managerial incompetence, political vulnerability, or environmental entropy. Whetten (1980b) differentiates between death (whether an organization still exists) and failure (causes of death). D'Aveni (1988) also makes a distinction. He defines decline as decreasing internal munificence for a given size of organization in terms of its financial and managerial resources and failure as unintentional bankruptcy.

From a managerial point of view, such a distinction in the definition of the problem serves to separate the severe from the not so severe situations. This study also makes a distinction between decline and failure. Failure is looked upon as a subset of decline. Decline is any fall in the financial performance of the firm leading to its weakening due to various internal and external factors. Failure (in the sense of impending failure) is viewed as the situation where the drastic fall in the financial performance is beginning to threaten the survival of the firm.

D. The Problem of Recognition

Taken together, the studies discussed in sections B and C above have helped highlight the existence of different levels of severity during the stages of decline and the implications for turning around the organization at the various levels of intensity. The implicit argument still is that the earlier the recognition takes place, the better are the chances for revival.

It is interesting that this question of recognition was among the earliest issues raised in studies of decline and turnaround. Schendel & Patton (1976) studying 36 pairs of firms drawn from the Compustat tapes found that turnaround is not simply a matter of finding the strategy that works, but it requires a "recognition of crisis which can require a change in management" (p. 240). While it is important to identify the appropriate turnaround strategy, it should be preceded by first defining the problem which requires recognition. The question of change in management, raised by Schendel & Patton, has been considered frequently in the literature (and will be discussed below), but the question of recognition has largely been ignored in the strategy literature. However, when we consider that the probability of internal recognition by management seems quite low, the importance of recognition gets reiterated.

The significance of the question of recognition is related with the issue of timing. It is not a matter of whether or not management admits failure or recognizes the crisis but whether it is done early enough. While deteriorating financial results and other signs of poor performance may be apparent, they may not be considered as indicators of severe problems. This raises the question of why it takes so long for some incumbent managements to recognize failure. It is "very often delayed until severe adversity has caused the firm to decay to a point jeopardizing its chance for successful reorganization" (Nelson, 1981, p.96). Cameron, Kim, & Whetten (1987) mention in a footnote that "with rare exceptions, organizations are turned around only after the internal organizational and personal consequences of decline are so pervasive and severe that a consensus around the need for drastic action grudgingly emerges"(p.225).

Miller (1977) remarks that "the plight of a failing firm comes as a great surprise to managers and shareholders alike"(p.43). Gilad et al. (1985) look particularly at the behavior of top management. Based on the notion of cognitive dissonance from psychology literature and crisis management from management literature, they conclude that under certain conditions involving a commitment to a course of action, information that the action is failing will be ignored, in contrast to the economic assumption of perfect (if not instantaneous) adjustment of beliefs to actual reality.

Lorange & Nelson (1987) also note that self-deception results from top managers commitment to an outdated view of the business's basic nature.

Staw, Sandelands, & Dutton (1981) provide a theoretical reasoning for the behavior of top management. Their 'threat-rigidity hypothesis' explains that there is a tendency for human beings to rely on well-rehearsed responses and to avoid, or to stop carrying out, less familiar responses. The issues of information distortion draws comment from Nelson whose study showed that at each level of adversity (low, medium, and severe), the information on which decisions are based is distorted. Firms facing `low' levels of adversity do nothing, those facing `moderate' levels improve their performance, and those facing `severe' adversity chose an `inappropriate' response.

These studies strongly suggest that while obviously the problem has to be recognized before corrective action can be taken, we are rather ignorant about the circumstances concerning recognition except to admit its importance. Moreover, the literature also suggests that the incumbent management is not likely to be among the early triggers. The chances of management's recognition is only when the severity is extensive and perhaps obvious.

E. Responses: Management Change

Considerable attention has been paid in the literature on the need for a management change as part of the turnaround. This presupposes that if an incumbent management were quick to perceive the tendency towards failure, it would have achieved a turnaround. If no steps were initiated or they were not successful, the argument would conclude, there is need for a change in management.

The matter of change in management being associated with or a precondition for turnaround has almost unanimous support. Hofer (1980) is very definitive. "A precondition for almost all successful turnarounds is the replacement of the current top management of the business in question....the current management has such a strong set of beliefs about how to run the business in question, many of which must be wrong for the current problems to have arisen in the first place, that the only way to get a more accurate view of the situation is to bring in new management"(p.26). Argenti (1976b) too requires a change in top management and Schendel et al. (1976) concluded that "income declines were causes for management changes " (p.8). Bibeault (1982) found that a new CEO was appointed in 74 percent of the cases to effect a turnaround. Schwartz and Mennon (1985) studied 134 bankrupt companies in the retail industry and found that companies often try to solve their problems by making leadership changes. They also found that firm size was a factor; larger failing companies that made such changes displayed a greater preference for external replacements than did the smaller ones. Other scholars (Altman & La Fleur, 1981; Bibeault, 1982; Dunbar & Goldberg, 1978; Finkin, 1987; Khandwalla, 1983; O'Neill, 1982; Starbuck et al., 1978; Williams, 1984) dwell on the need for or inevitability of management change.

The gist of these arguments is that the existing management is usually the cause for decline, even if it is not, a scapegoat is needed to take the blame, the existing team does not have the credibility to manage the turnaround, and a symbolic act is needed at this stage to signify the onset of change. However, there are two unstated assumptions in this argument. One is, who initiates the change? While administratively the Board of Directors (BOD) may give effect to the change, very few scholars have examined the question of how the change gets initiated. Dunbar and Goldberg (1978) studying 20 randomly selected cases on mismanagement from the German `Manager Magazin' categorically conclude the BOD had failed to perform their role. The second issue is that if a management change is not possible, as for instance in owner-managed concerns, are there other means of intervening in the situation to bring about recognition of the problems and initiate a turnaround.

F. Response of the CEO

Once failure has been recognized and the need for turnaround admitted, either the existing management or the new one would have to initiate action. Broadly termed as `turnaround strategies' these have been considered extensively in the literature. Hoffman (1989) provides an excellent review of them and indicates areas for further research. The details of turnaround strategies not being within the gambit of this study, a broad review will be provided below as a backdrop.

The discussion on turnaround strategies has been with a varied focus - dealing with content (strategic & operational measures), process, and a combination of both. While some have looked at strategic (Thietart & Vivas, 1984) and others at operational issues, there is often no conflict between the two (Hofer, 1980; Hambrick & Schecter, 1983). Immediately upon commencement of revival effort efficiency moves become critical but the need for strategic re-evaluation cannot be denied. Those looking at operational factors have invariably moved on to examine the process of implementing the strategies (Williams, 1984; Finkin, 1985; Zimmerman, 1987). No two turnarounds are the same and by highlighting the structural and behavioral factors, these scholars have provided effective checklists for any turnaround manager to consider. The bulk of the writings in the literature do not distinguish between content and process and intertwine them in the discussion (Argenti, 1976a; Bibeault, 1982; Lorange & Nelson, 1987; Ross & Kami, 1973).

However, in requiring a management change or a new CEO, there is an implicit assumption in all these studies as to the supremacy of the management in formulating and implementing a turnaround strategy which is dictated directly by the causes of decline. There is no consideration of the possibility of external influence on the management in the formulation or implementation of a new stratetgy. This need not always be true, especially in the situation in which a failing firm finds itself. This researcher (Gopinath, 1989) in a study of 22 firms from published sources, found that there are considerable external influences on a firm at the stage of decline when there is open recognition of its problems and further, the source which recognizes the decline as being severe and initiates action has an influence on the turnaround strategy followed. While it is not always possible to identify the single most important source of influence, the role of an external agency is important to be recognized and studied. Because these external agencies come from different perspectives, their recommendations for a turnaround strategy may not correspond with what the firm might ideally prefer. The initial actions taken by the firm are usually considered as a part of the turnaround strategy. They, however, need to be looked upon differently (called `immediate term strategy') since the objective at this stage is still to stem the decline and not yet turnaround, and some of the actions may contradict its turnaround strategy. This study concluded that there is a `critical phase' intervening between decline and turnaround which begins with the recognition of the severity of the problems facing the firm and extends till the decline is stemmed and the organization prepared for a turnaround. The contents of this phase were specified as including the question of who recognizes the failure, the process by which action is precipitated, whether management changes take place, the decision on liquidation versus turnaround, and the content of the immediate term strategy.

To sum up, the review of related literature shows that the lack of clarity surrounding the recognition of decline is an important gap in our understanding of the decline process. There have been several efforts at understanding and classifying the causes of decline and recent studies are beginning to map various paths followed in the decline phase. The need for early recognition has been indirectly approached by studies in the accounting field aimed at developing models to predict failure using accounting ratios (Altman, 1983, provides a review). Used as part of an internal information system, they serve as one more index of declining performance. However, the managerial issue of differentiating between the severity of the decline and accepting the situation as a matter of concern which could lead to failure remains. While there has been some passing mention in the literature of the need to recognize the problem before action is taken, problem recognition has not been studied considering its importance from the view of timing. Moreover, while studies have shown that the management is likely to delay recognition for various reasons, and a change in management is a possible precondition for turnaround, the possibility of external recognition, how management change could get initiated, and external influences on the turnaround strategy have not been studied. The next chapter will review the probability of an external source of recognition and its influence on the strategy of the firm.

CHAPTER III

A CONCEPTUAL FRAMEWORK

> "Turnaround is not simply a matter of finding the strategy that works; turnaround is much more complex and clearly requires: one, a recognition of crisis which can require a change in management and a financial squeeze to motivate change;...".
>
> - Dan Schendel and G.R.Patton (1976, p.240)

In this chapter, the theories developed and used by various researchers in studying issues concerning decline will be reviewed to build a framework for examining the questions raised earlier.

A. Theories

Leading scholars have, at various times, bemoaned the absence of an accepted theory in this field (Whetten, 1980a) which is typical of any new field of study. The literature tends to be rarely cumulative and widely dispersed (Cameron, Sutton, and Whetten, 1988). Among the more popular ones are the population ecology model and the organizational life cycle theory. The models on crisis management have been used by fewer scholars. Whetten (1980b) provides a concise review of natural selection and organization level models which will be briefly examined here. The next section will go into the crisis management literature.

Most studies looking at external causes of decline have used the perspective of population ecology; that environments select some organizations for extinction and allow others to survive. As propounded originally by Hannan & Freeman (1977), natural selection occurs as some variations in behavior are eliminated because they are undesirable and others are reinforced because they work. The criterion of effectiveness is survival. In its pure form it is very deterministic, mystifying and removes much of the power, conflict, disruption, and social-class variables from the analysis of social processes (Perrow, 1986). McKelvey and Aldrich (1983) modified this idea by paying attention to the internal competencies of organizations, trying to specify the adaptations that permit survival, including the role of government policies that change the environment, and specifying how competencies become retained within the organization. Zammuto and Cameron (1985) have specifically applied the population ecology approach to decline and looked at the decrease in a niche's carrying capacity for current activities as well as qualitative shifts within a niche to support the activities. They come up with four forms of decline defined in terms of erosion, contraction, dissolution and collapse.

The notion of adaptation to the environment is one which is easily accepted since there is still an element of choice and decision making in the hands of the managers. It is used by several researchers (Boulding, 1975; Dunbar & Goldberg, 1978; Miller, 1977; Ross & Kami, 1973; Scott, 1976; Sutton et al., 1986; Whetten, 1980) to explain, at least partly, the reasons for organizational decline other than `bad management'. But on purely theoretical grounds, this approach still suffers from problems. One is the very definition of population of organizations and what this includes or excludes. Moreover, with a constantly changing environment, the behavior required for survival is also constantly changing so that adaptations learned at one time may not serve subsequently. If adaptation by the industry is slow, less than optimum members may be able to survive longer. "Companies that satisfice, searching for optimal actions only when competitive pressures are unusually intense, are apt to be especially viable...when firms with monopoly power are shielded by entry barriers, product differentiation, government favoritism, and the like, threats to their survival may be sufficiently blunted that they can survive for decades without ever maximizing profits or minimizing costs" (Scherer, 1980, p.38).

Another useful lens for the study of decline are the organizational life cycle models. These models use the life cycles analogy to view organizations in terms of birth, maturation, decline, and death. They are however more popularly used for study of growth rather than decline or death due to problems in gaining data on dying organizations and the obvious conclusion that not all mature organizations decline and die (Whetten, 1987). The models also suffer from a lack of clarity of how literally they should be applied to the study of organizations, the deterministic nature of the stages, and whether movement through them is linear or recursive. There are also strong linkages between the organizational life cycle and the population ecology literatures in looking at the consequences of decline, but they also attract the same criticism of being too deterministic and not allowing for the conscious efforts of human beings (Penrose, 1952).

To conclude, these models being externally oriented are useful to look at external effects on an organization, or adaptation to changing environments, including turnaround strategies. They however do not lay sufficient emphasis on the internal aspects to answer some of the issues raised in the previous chapter. The models of crisis management provide useful insights and these will now be reviewed in greater detail to develop a conceptual framework for use in this study.

B. Crisis Management Literature

Many scholars use the word `crisis' in describing decline or events during a decline. However, very few have used the theories in the crisis management literature to analyze the decline phase.

In the literature on crisis management, the word `crisis' is defined as a situation that 'threatens the high-priority goals of the organization, restricts the amount of time available for response and surprises decision makers by its occurrence, thereby engendering high levels of stress' (Hermann, 1963). In a typical industrial crisis situation such as Three Mile Island or the Bhopal disaster, the elements of surprise, high threat, and short decision time can be easily discerned. A disaster can be looked upon as a specific case of a crisis since the precipitating event is obvious.

Billings, Milburn, and Schaalman (1980) extend Hermann's model to make it more explicitly perceptual since crisis is defined by a set of variables as perceived by the decision maker and therefore it resides in the person as well as in the situation. They also explicitly include the event which triggered the crisis. This is an important distinction which was originally introduced into the literature by Turner (1976) as an important first step in perceiving the situation. Indicators can be disregarded or misinterpreted due to the complexity of the information, rigidities in perception and belief, or disregard of the perceptions of outsiders. According to his thesis, the crisis can thus develop into a disaster. Fink, Beak and Taddeo (1971) define crisis as a state of an organization when its repertoire of coping responses is not adequate to bring about the resolution of a problem which poses a threat to the system. They add that most often it is precipitated by an identifiable event, either within or outside the system.

A crisis may or may not lead to organizational failure, and while crisis is usually sudden, decline can be very gradual (Argenti, 1976; Hambrick & D'Aveni, 1988). Models in crisis management also make the distinction between a problem and a crisis which is akin to the distinction between decline and failure. Cowan (1986) presents a model of what takes place prior to the problem being labelled as a crisis. In order to understand the problem recognition process, he draws on the information processing literature to capture key activities and their sequence. He suggests that individuals move among three stages: gestation, categorization, and diagnosis. If suitable corrective action is not taken, the problem develops into a crisis.

Since they deal with very similar issues, insights gained in this field of crisis management can be adapted for study in the field of failure. By including the notion of recognition and triggers, and distinguishing between problem and crisis, the crisis management concepts are eminently suitable for examining business failures. A few authors have used aspects of the crisis literature to understand organizational decline. Defining crisis as times of danger when some actions lead towards organizational failure, Starbuck et al. (1978) look for internal and external reasons for the crisis, reasons for resisting change, need for constant learning by the organization, etc. Smart et al. (1978) develop a model for identifying those configurations of attributes which increase or decrease the vulnerability and susceptibility of organizations to crises. But the analysis deals with only strategic and does not include operational factors. In analysing 40 turnaround situations in the UK, Slatter (1984) finds the models of crisis management very appropriate.

C. The Process Model of Recognition

The review of crisis management literature from the perspective of studying business decline provides important elements to serve as the basis for this study. The first is the distinction in the severity of the situation as being a problem or a crisis. This can have different implications for responses to the situation. The second is the importance of recognition of the problem or the crisis. It is possible for the `problem' to develop into a `crisis' (or become a disaster) if there is no recognition. The third is the suggestion that there is a need for triggers to bring about recognition, and these could also be the events which cause the crisis. We have seen earlier that there is a strong possibility of an incumbent management not recognizing the problem. This immediately suggests the need for or the possiblity of external recognition. While the literature on strategic management is silent on external recognition, it has been taken note of as being an important first step, in the accounting field (McAuliffe, 1987).

A decline in financial performance in usually not a sudden event but occurs over a period of time (Slatter, 1984). During this period, the normal slack in the organization prevents the firm from failing and slipping into crisis (D'Aveni, 1988; Hambrick & D'Aveni, 1988). The downward spiral results in a lingering decline and paralysis. If no corrective action is taken, firms could continue in that state until a crisis (Schendel & Patton, 1976; Bibeault, 1982). The need for a turnaround is usually present in the period of managerial complacency which tends to precede the onset of a crisis (Slatter, 1984) but it is not easy to diagnose since the management systems and processes which produce crisis are substantially the same as those that produce success (Hedberg, Nystrom & Starbuck, 1976).

The elements of a crisis described earlier, viz. surprise, high threat, and short decision time, cause stress which affects managerial behavior (cognitive performance), which often diminishes the quality of decision making. Holsti (1978) identifies the major effects of crisis-induced stress as being a reduction in management's span of attention, an increase in their managerial inflexibility and a reduction in their time perspective. This creates a situation where outside intervention is necessary to trigger the change process (Slatter, 1984) which could include a change in management. If the problem is identified early enough, the same order of strategic change in terms of product-market reorientation, financial policy, etc. may be necessary but the extent of organizational change would be far less or possibly accomplished in a less painful manner. The many possible sources of external triggers include banks, investor groups, auditors, government, labor union, etc.

Nelson (1981) arguing in favor of economic self-interest, says that bankruptcy is .."triggered only when economic actors perceive that the process will promote their interests" (p.95). From this perspective, he discusses the role of stockholders, directors, executives, and creditors (secured and unsecured). He describes how each one would be affected differently by the choices facing the firm. But he provides only institutional descriptions of the hardships facing firms threatened by bankruptcy and does not offer an alternative model which formalizes the disequilibrium or the adjustment process.

Fig. 1 (p. 36) provides a conceptual representation of the issue of recognition during the decline phase. When an organization slips into a decline phase and there is internal recognition, corrective action could be initiated leading to a successful outcome. The internal recognition could, and often does, come as a result of a crisis such as liquidity, departure of key personnel, etc. If either there is no internal recognition or the actions do not cause a turnaround, the stage is set for external recognition and intervention. This could happen as a result of a crisis or the process of external recognition could represent the crisis. The role of the external agent in the process of precipitating the crisis/creating the internal recognition would also extend to influencing the corrective action due to their stake in the existence of the firm. During this `critical phase' as described earlier, action is taken to stem the decline, management change(s) may take place, and the organization is ready for a turnaround (revival) or liquidation.

D. Commercial Banks and Their Role

Virtually no business firm, small or large, operates without bank loans, whether an operating line of credit or a term loan. Though being an external agency, banks are privy to confidential information about a client through receipt of regular reports as required under the loan covenants, and they closely monitor the performance of their clients in order to protect their (banks) assets. Commercial banks, thus, become ideally situated to perform the role of an external trigger.

As a trigger and indeed as an influential player in the entire turnaround process, commercial banks seem to occupy a pivotal position in many firms' rescue. In the U.K. context, Slatter (1984) mentions that it is usually the banks that initiate the turnaround process. He argues that "the trigger for change during a severe crisis is more likely to be an intervention from an outside source, most commonly banks or lending institutions" (p. 75). In Japan also, where commercial banks often hold at least a nominal amount of their client's equity, they play a dominant role in the turnaround. In the U.S. while authors have examined the concerns surrounding a bank's response to problem loans (Bauch, 1987; Nemer, 1982), the content and process of intervention has not been empirically studied. Of late, the negative aspects of this influence has been brought into the limelight because of a tendency on the part of some bankrupt firms to blame the banks for their failure (Gubernick,1986; McLaughlin,1986) and sue them on the grounds of lender liability, i.e. that the banks did not respond to their requests for additional assistance or influenced in a manner leading to their failure.

From the banking perspective, problems in a client firm affecting its performance and repayment capacity fall within the purview of problem loans. These are defined as loans which present problems as far as collection of interest and/or principal are concerned and can result in losses to the bank. Loans, for a bank, are its assets and any problem in them directly affects not only the income but also the balance sheet of the bank. Problem loans and losses are the result of many factors, mainly either unwillingness to repay or inability to do so. Reed (1963) is representative of many authors who point out that "only an infinitesimally small percentage of the borrowers become unwilling to repay loan obligations" and "the major reason by far for problem loans and possible losses is the inability of borrowers to realize income from normal business operations.."(p.400). Thus, the bank's view of problem loans is a surrogate of a managements view of its decline.

The banking literature further recognizes (Hatch & Wynant, 1986) that management is often slow in admitting the problem requiring close monitoring by the bank which may have to "spur management into action" (p. 250) and that it is critical that the banker take action at an early stage. Argenti (1976b) considers the role of the bank in supervising management so important that he recommends a bank's representative be appointed on the boards of companies which have significant borrowings.

E. Cash Flow Crisis and Recognition by the Bank

Among the early signs of decline in a firm's performance is the problem of a worsening cash flow leading to a liquidity crisis. Schendel and Patton (1976) in raising the importance of recognition of the crisis suggest that it can cause a change in management and a financial squeeze to motivate the change. There are several studies in the accounting literature on the use and reliability of cash flow as against other financial ratios for prediction of failure (Casey and Bartczak, 1984; Zeller and Mendelow, 1989). However, there appears to be no disagreement on the occurrence of cash flow crisis during a severe decline in the financial performance of the firm and when internal slack has been used up. While there is disagreement on whether a bank will force liquidation of a problem loan and the conditions under which it is advantageous to do so (Bulow and Shoven, 1978; Ang and Chua, 1980) the importance of the commercial bank to the firm during its liquidity problems is beyond doubt. This importance is reiterated by the study of Giroux and Wiggins (1984) of 22 bankrupt and 26 non-bankrupt firms which shows that net losses, debt ideally situated to perform the role as external agents who closely monitor the performance of their clients to protect their own interests. While the implicit assumption of strategic management is that the CEO (incumbent or new) is supreme in formulating a turnaround strategy, the admission of an external agent performing a crucial role of recognition lays open the fascinating possibility of the same agent's responses to the situation as being an external influence on the strategy. This has helped to develop a framework of external recognition and response to serve as a scaffolding for this research.

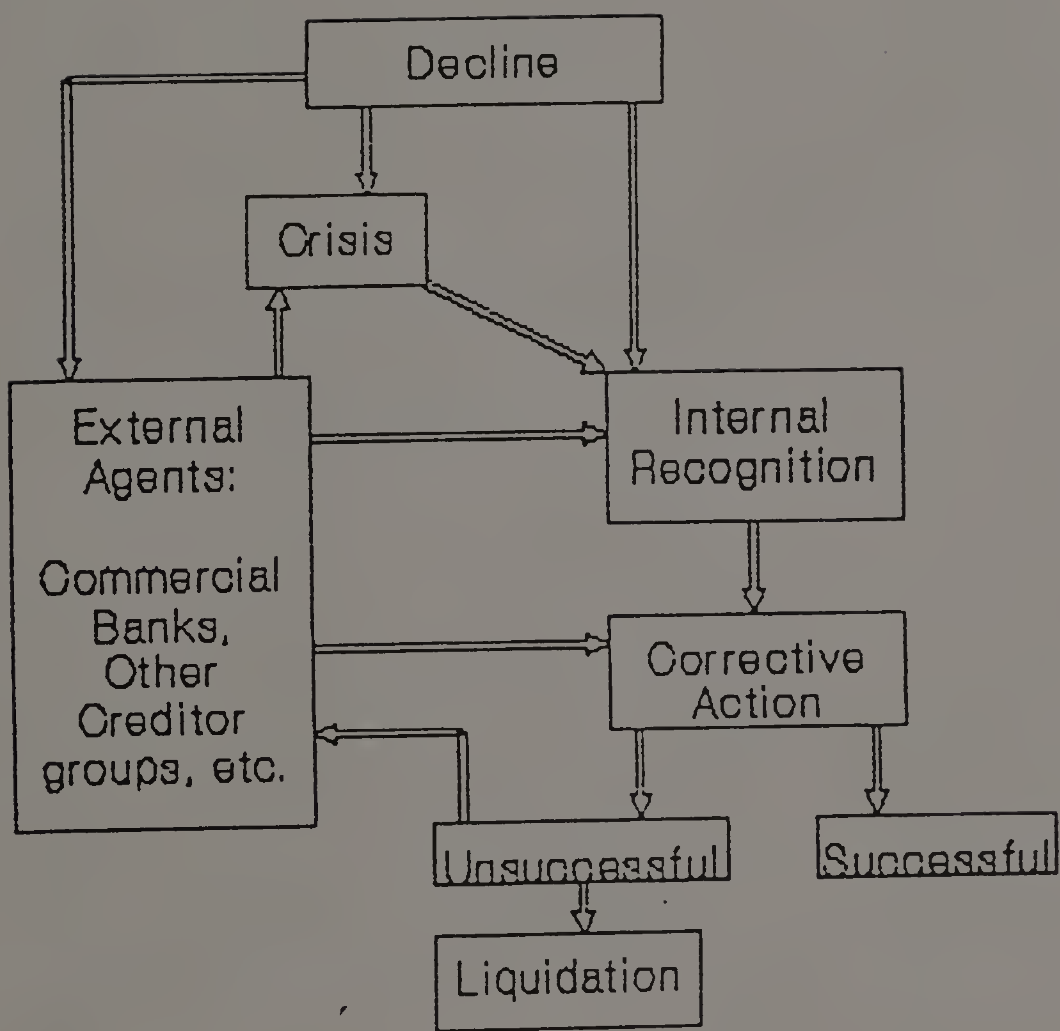

Fig.1 Process Model of Recognition

CHAPTER IV

RESEARCH METHODOLOGY

> "It is far better to have an approximate answer to the right question, which is often vague, than an exact answer to the wrong question".
> - Catherine Marshall & Gretchen Rossman (1988, p.17)

Empirical research in turnarounds has suffered from several difficulties. Given that the general business culture is preoccupied with growth and profitability, there is a tendency among managers to avoid talking about decline and questions may result in a display of emotion, in addition financial support is also difficult to obtain (Cameron, Sutton & Whetten, 1988). One must often contend with a reluctance to divulge complete information in situations where cover-up's and scapegoating are not uncommon. Moreover, the nature of the phenomenon is such that an organization is most easily identified as having failed after the failure has taken place and the organization is in the process of a turnaround or liquidation. Due to these problems, empirical ressearch into decline and crisis have been minimal. Moreover, these limitations and the issue of confidentiality have forced researchers make compromises and settle for less than the optimum in data sources, and hence accuracy. Therefore much of the research has relied on published information and has often used bankrupt firms as their data points since data is more readily available on them.

In this chapter, a brief overview of past empirical research will first be made before discussing the data sources, collection methods and techniques of analysis in this study.

A. Overview of Empirical Research

In this section, the nature of data used for empirical research into decline, in the form of secondary data, case histories, and primary data will be reviewed.

1. Secondary Data: Large Data Bases

A survey of the research in this field shows a preponderance of studies using secondary data from large data bases. The sources used include Business Failure Record (Dun & Bradstreet), S&P Register, COMPUSTAT, PIMS, Moody's Industrial Manual, and the D&B Directory. The bulk of the work, using both univariate and multivariate statistical analysis, has been in prediction of failure with company financial data (Altman, 1983; Beaver, 1966; Giroux & Wiggins, 1984; Keasey & Watson, 1987; Sharma & Mahajan, 1980). Giroux & Wiggins and Keasey & Watson supplement their approach with non-financial data. Sometimes, as Schendel et al. (1976) did, the database is used only to identify firms satisfying certain criteria, and then the analysis is done using case material.

Often, the firms are identified on the basis of bankruptcy filings (Altman, 1983; Hambrick & D'Aveni, 1988; LoPucki, 1983; Nelson, 1981; Sharma & Mahajan, 1980; Schwartz & Menon, 1985; Wilcox, 1976) and then the variables are operationalized using the accounting data from the data bases and supplemented from company annual reports.

While most of these studies have looked at the decline phase, the studies using databases to study aspects of turnarounds have been by Hambrick & Schecter (1983) and Ramanujam (1984) who studied the effect of environmental and organizational contexts on turnarounds.

For pure research methodology purposes, Begin, Cesta, and Apilado's (1979) study is valuable as it compares data on business failure rates from the only two publicly available sources available viz. the D & B Business Failure Record and the bankruptcy records of the US Administrative Courts. When using published data, it is important to be careful about the assumptions made and definitions used in collection which could be very different from those of the researcher. Begin et al. clarify the differences which exist between these two data bases and highlight the consequences of accepting one versus the other for analytical and policy development purposes. While both sources seek to measure the same thing, they both rely on sample rather than census. Since they do not describe the same underlying population, use of one or the other for cross-sectional or time series investigations of business failures/bankruptcies might lead to very different conclusions.

2. Case Histories

Case histories appear to be the second most popular source of information as it provides the richness of detail which is valuable for looking at the content and process of turnaround. The case studies which are either available as cases or put together by the researcher from published sources such as the journals and the popular press, are content analyzed. Miller & Friesen (1977) uniquely undertake fairly sophisticated quantitative analysis using the scores on 31 variables on a 7-point scale given by raters to the cases. Others (Dunbar & Goldberg, 1978; Hall, 1980; O'Neill, 1982, 1986; Richards, 1973; Schendel et al., 1976; Zimmerman, 1986) use case material to arrive at common strategies and patterns in the process. In-depth studies of a single case have also been used (Altman & La Fleur, 1981; Finkin, 1983; Sutton et al., 1986) by researchers to either illustrate a conceptual argument or to draw conclusions from them.

3. Primary Data

Data collected through questionnaires, interviews, and field research has not been as extensively used. Looking at failure related problems, Cameron et al. (1987) used data from educational institutions to look at attributes and dysfunctional effects of decline, using sophisticated quantitative techniques. Behavioral issues particularly associated with the triggering of bankruptcy are dealt with qualitatively by Nelson's (1981) sample of 13 firms.

Harrigan (1980) also qualitatively analyses the strategies followed by firms in declining industries and collected data from firms, interviews of individuals, suppliers, industry associations, etc. Bibeault (1982) in his survey of 81 CEO's, uses summary statistics to look at the causes for decline and turnaround strategies.

It is a researchers dream to be able to obtain perfectly objective and large amounts of data on a random basis for his study. Most often compromises must be made to suit the situation. While randomness and a large `n' is possible using the data bases, they end up dictating the operationalization of the variables and thereby limit the issues which could be studied. Moreover, as only large publicly held firms are included in these sources, there is an inherent bias in size against the small and medium size enterprises. Primary data, as explained earlier, is most difficult in this field as firms in a state of decline do not have the time, and/or the inclination to welcome researchers (Weitzel & Jonsson, 1989).

B. This Study: Objectives and Research Questions

This study was undertaken to gain a better understanding of the question of recognition of firms in decline and the related external influences on turnaround strategies. This was achieved by looking at commercial banks' identification of problem loans and reactions of the banks to the situation.

There are several advantages to this approach. As explained earlier, a commercial bank is an external agency which has access to confidential information about the performance of a client firm. In order to protect its assets, it is engaged in continuously monitoring the performance of its client, and is therefore ideally situated to make an early recognition of the decline. The additional advantage of taking the view of the bank is the dynamic aspect of capturing the information while the event is current. Billings et al. (1980) who surveyed organizations and institutions which had in the recent past experienced a crisis due to curtailment in gas allocations, comment that the ideal design would have been to gather data during the crisis. Cameron et al. (1988) comment that few studies exist using the process approach to decline.

The lack of an understanding of the external influences on recognition points to the need for an exploratory study. Commercial banks having been chosen as an influential trigger, it is necessary to discern the cues used to identify the problem loan, the process of identification, the nature of response, and the various factors which influence the response. An exploratory study using quantitative and qualitative methodologies would be able to clarify the process and identify variables of importance for further research. Thus it is believed that this study would contribute to a better understanding of an important element in the decline process.

In approaching this study, the following were set as the areas of inquiry.

1. Failure Recognition

It has been argued earlier that when there is a decline in the financial performance of a firm, it need not be immediately life threatening. Even when it is, chances are that the incumbent management is usually among the last to recognize the failure. A distinction can be made between a fall in the financial performance of the firm (decline) and when the decline is threatening the very existence of the firm (failure). The commercial bank is uniquely positioned to make this distinction since it is an external agency with access to detailed information and banks monitor clients' performance as part of a regular review. It would therefore be useful to inquire into whether such a distinction is made and the criteria used, leading us to the following two questions:

Q1.1: Does a commercial bank make the distinction between decline and failure?

Q1.2: What are the criteria they use to make this distinction?

2. Response of the Banks Following Problem Recognition

Once a bank recognizes their loan to be at risk due to the client being in a decline or impending failure, this fact would trigger some responses on the part of the bank. The reasons for the decline could be several and the banks not being experts in managing the units might take time either to watch for further deterioration or to study the decline. Moreover, there are conflicting objectives influencing the responses of the bank. These include the issue of lender liability (the liability attributed to a lender arising out of wrongful action or inaction towards a defaulting borrower), the public image of the bank, need to protect the loan risk of the bank, and the need to retain a client given competitive market conditions. In addition, there could be the desire to give management the benefit of doubt. Thus, even if the bank recognizes a problem, there could be a delay before it warns the client. This raises the following two questions:

Q2.1: What is the nature of the lag between recognition of failure and response to it?

Q2.2: What factors would explain this lag and what could be the consequences of it?

As the consequences of decline and failure are different for the client and the bank, the latter would be expected to respond differently to each. The responses of a bank can be characterized as financial (extension of credit, deferment of interest, additional collateral/guarantees), managerial (change management, assistance in financial controls, strategic planning, etc.), or legal (steps to recall the loan). These responses are essentially interventions in the client's situation. To understand this better, we need to inquire into the following:

Q2.3: What is the array of responses available to a bank following recognition of a problem loan?

Apart from conflicting objectives, various characteristics of the client influence the timing of response including the size of the client, whether the loan is secured or unsecured, the bank's estimate of success in recovery of funds, etc. Studies of bank officers' ability to predict failure have shown variance due to individual differences in information processing style (Casey, 1980). This leads to the following two questions:

Q2.4: Do banks follow a common approach in their response to problem loan situations ?

Q2.4: What factors would influence their response in addition to their analysis of the causes of the problem?

3. Influence of the Banking and Regulatory Environment

Banking is one industry which is regulated in one form or the other all over the world on account of its key position in the economy. The several influences in the environment would also affect their behavior, especially in dealing with problem loans. Differences in the size of the banks, regulation and bankruptcy legislation can affect a bank's approach. In order to look at the environmental influence, it was felt that banks in the US and Canada would provide a useful comparison.

The nature of the regulatory environment banks operate in differs between the Canada and the US. (Appendix A provides a brief look at the differences in banking structures and bankruptcy legislation between the two countries). Apart from specific regulations controlling the operations of banks, the dominant belief in the US is to allow free market forces to operate to decide the survival of the firm. However, there is a greater expectation of bank response including the size of the client, whether the loan is secured or unsecured, the bank's estimate of success in recovery of funds, etc. Studies of bank officers' ability to predict failure have shown variance due to individual differences in information processing style (Casey, 1980). This leads to the following two questions:

Q2.4: Do banks follow a common approach in their response to problem loan situations ?

Q2.4: What factors would influence their response in addition to their analysis of the causes of the problem?

3. Influence of the Banking and Regulatory Environment

Banking is one industry which is regulated in one form or the other all over the world on account of its key position in the economy. The several influences in the environment would also affect their behavior, especially in dealing with problem loans. Differences in the size of the banks, regulation and bankruptcy legislation can affect a bank's approach. In order to look at the environmental influence, it was felt that banks in the US and Canada would provide a useful comparison.

The nature of the regulatory environment banks operate in differs between the Canada and the US. (Appendix A provides a brief look at the differences in banking structures and bankruptcy legislation between the two countries). Apart from specific regulations controlling the operations of banks, the dominant belief in the US is to allow free market forces to operate to decide the survival of the firm. However, there is a greater expectation of bank and government involvement to assist firms in Canada (Bank Facts, 1987). There are also differences in the Bankruptcy Acts governing business in the two countries. The lack of a Chapter 11 protection in Canada has been mentioned as part of the reason why banks recall loans and force small to medium enterprises into liquidation than might otherwise have been possible (Francis, 1988). This leads to the following question:

Q3: Given the differences in the banking and regulatory environment, how do the Canadian and US banks differ in the areas of recognizing business failure and responding to them?

The research approach used may be termed triangulation, which is defined as a combination of methodologies in the study of the same phenomenon (Denzin, 1978). Given the difficulties of studying decline during its occurrence, a mix of quantitative and qualitative methods in a complimentary manner (Jick, 1979; Rossman and Wilson, 1985) was chosen as the most appropriate. The qualitative approach consisted of interviews. The quantitative approach was reflected in the data collected through administering a questionnaire. These will be discussed in greater detail below.

C. Data Collection

The source of data for the study was commercial banks. Through the assistance of faculty in the School of Business, University of Massachusetts, cold calls, and personal contacts of the researcher, six banks in the US (mostly New England area) and four in Canada (Montreal/Toronto area) were approached. The objectives of the study and method was explained to them. They were also assured of total confidentiality of the names of the bank, its officers and clients.

In the first stage, the main or initial contact in the bank was appraised of the study and its intentions. (Appendix B gives a sample of the letter written to the banks.) On securing an appointment, a verbal presentation was made and their participation requested in permitting (a) interviews of one or two officers, both at senior policy making levels in the lending or workout functions and at the loan officer level, and (b) administering questionnaires to a larger number of account managers/loan officers who would have problem loans in their portfolio. All the four banks contacted in Canada agreed to participate in both aspects of the study, but completed questionnaires were received from only three of them. Of the six in the US, two declined to permit distribution of questionnaires and restricted the number of interviews. Many banks in the Northeast region are currently going through a bad phase with an above normal percentage of non-performing loans due in part to the depressed real estate market. This could account for their reluctance to permit an outsider inquiring into their methods of responding to problem loans.

1. Interviews

In-depth interviews were held with bank officers involved in:

a) lending (at the senior policy making level and account managers/loan officers who deal with the clients),

b) loan review, an internal department which reviews accounts on a regular or random basis to detect problems in loans, and

c) workout, the department usually charged with the responsibility of working with the client and turning it around or liquidating and collecting the loan.

In addition, to get the regulatory perspective, one official of the Office of the Superintendent of Financial Institutions, Canada, and one from the Massachusetts Department of Banking were interviewed.

At the time of fixing appointments over the telephone, officers were given a brief summary of the objectives of the study and told that the interview would last between 45 minutes and an hour. The interviews were conducted in a semi-structured format and Appendix C lists the questions which were used as a guideline to ensure the basic issues are covered. During the course of the interview many of the issues were developed further. At the beginning of the interview the permission of the interviewee was sought for recording the discussion. Except in the case of two officers, they were all tape recorded and transcribed. The interviews lasted 1 hr each on an average.

<u>2. The Questionnaire</u>

The questionnaire was designed to seek specific information from the level of the loan officer/account manager on particular problem loan cases. (Appendix D includes a sample). It contained an introductory letter explaining to the respondent the intent of the study and providing instructions regarding completion. The cover letter included the name of the bank so it was possible to identify the respondent's bank but there was no requirement for the respondent to be identified.

There were two parts to the questionnaire. Part A contained questions about the respondent such as years of experience, number of problem loans handled, ways of monitoring loans, etc. Some of the questions included space where the respondents could include `other' options in the response and two of the questions were open ended covering how problem loans are recognized and whether a distinction is made in the severity of the problems facing the client. Part B asked the respondent to keep one current problem loan client in mind and answer the questions with reference to that client. The cover letter requested the officer to choose a client who had been in existence for five years. (This was, however, not always possible.) This was done to eliminate start-up firms which suffer from other problems beyond the scope of this study. Two copies of Part B were included in every questionnaire set with a request that if the respondent could think of another problem loan in his/her portfolio spanning a different set of issues, the second copy could be used to respond. There was no requirement for the client to be identified and the copies were differentiated with a client code `I' and `II'. The variables included under topics such as "cues for recognition", "causes for decline", "objectives influencing the response", and "different types of interventions being considered" were drawn from a review of the current literature including Reed et al.(1984), Argenti (1976), and articles appearing in the Journal of Commercial Bank Lending. The questionnaire was pre-tested by four officers and revisions were made to take into account their comments.

The distribution of the questionnaire was left entirely to the discretion of the contact officer in the bank. Once the officer permitted (or obtained permission for) distribution of the questionnaire, the number of copies specified by him/her was provided. (The officer was requested to distribute the questionnaires to those who currently had problem loans in their portfolio). A self-addressed stamped envelope was provided in the sets distributed in the US. The Canadian ones were not pre-stamped but as can be seen from the response figures, this did not materially affect the response rate. Though distribution was through one officer in the bank, all completed questionnaires were to be mailed directly to the researcher. Therefore the respondent was assured that the bank officials would not know about his/her responses. In the case of one Canadian bank which intended distribution to officials in the Quebec area, a French translation of the questionnaire was provided.

D. Data Overview

This section will provide a brief review of the data in terms of the banks/loan officers studied and the clients (problem loan cases) on whom the information was reported.

1. Bank Data

Table 4.1 provides information on the banks and loan officers. The number of banks in whom interviews were conducted and/or questionnaires obtained were six in the US and four in Canada. Fourteen officials in the US and eleven in Canada were interviewed.

The number of loan officers who returned completed questionnaires is 23 in the US and 90 in Canada; they reported on 34 and 146 clients respectively. Canadian banks being larger in size, have a larger number of loan officers who may have problem loans in their portfolio. The US banks being smaller in size, there was a limited number of potential respondents. In addition, the extent of cooperation in the study was distinctively higher among the Canadian banks contributing to a larger response. (Three of the returned questionnaires from Canada were unusable due to missing pages). The average years of experience of the loan officers was similar in both the countries, about 11.2 years. The mean number of problem loans handled by each officer over these years was not significantly different and was about 39. These figures also show that experienced officials responded to the questions giving credibility to their responses. A majority of the respondents (85%) do not specialize in any particular industry in their lending activity and can be considered as generalists.

2. Client Data

As mentioned above, the loan officers provided information on 34 clients in the US and 146 in Canada whom they considered problem loans. (Table 4.2 provides summary information about these clients). Client firms were distributed over seven different categories of businesses. The majority of client firms in the US were in retail, finance, insurance and real estate, or services, while in Canada, they were mostly distributed between mining & manufacturing, retail and services. Quite a few were in construction in both countries and were classified under `others'.

In order to avoid the cases of start-up failures (which involves other reasons beyond the scope of this study) the respondents were requested to preferably choose firms at least five years in existence. In our sample, 68 percent in the US and 58 percent in Canada were six years or older. (85% of the US firms and 75% of the Canadian firms were older than three years.) While there were no stipulations regarding type of management, an overwhelming majority (94%) in both countries were owner managed. In terms of size, 59 percent were considered small and 41 percent as mid-market accounts. The important implications of the size and management issues will be discussed in the next chapter. In the case of 79 percent of the US and 77 percent of the

Canadian firms, the reporting bank was the sole bank. If one includes the cases where they were at least the lead bank, this percentage rises to 82 and 98 respectively. We conclude that the views of the loan officer of the bank is that of a dominant lender.

E. Data Analysis Methods

The qualitative data obtained from the interviews and the responses to the open-ended questions were analyzed through systematic methods. Miles and Huberman (1984) provide an exhaustive review of the methods available. In brief, the process followed in this study involved going over the transcripts to identify low-level categories which were noted on index cards. These were then combined over different iterations during which patterns started emerging. Turner (1988) calls this process of sorting out and classifying the issues as trying to `botanize' in the same manner as a botanist would.

The quantitative data obtained was studied using univariate statistics and relationship between variables was studied using correlation and regression techniques. Data reduction methods such as factor analysis was employed to see the groupings among the variables. Differences between the US and Canadian samples were studied using t-tests. A regression model was also developed to understand the influence of different variables on the responses of the bank.

The next chapter will present a description of the main observations of the study and their implications.

Table 4.1
Bank Data

Item	U.S	Canada
No. of Banks participating	6	4
Persons interviewed	14	11
Completed questionnaires received from Loan Officers	23	90[1]
No. of problem loan cases reported	34	146
Mean experience (years) of the loan officer (s.d.)	11.9 (6.4)	11.1 (7.5)
Mean number of problem loans handled by the officers (s.d.)	40.4 (53.7)	38.5[2] (42.8)
% of loan officers who do not specialize in any particular industry	83	85

Notes : 1) 3 questionnaires received had pages missing and were excluded.
2) One outlier reporting 'over a thousand' excluded.

Table 4.2
Client Profile

Item	U.S	Canada
No. of cases (firms)	43	146
Age of the business (% distribution)		
Less than 3 years	15	22
4 - 5 years	18	20
6 - 10 years	21	20
More than 10 years	47	38
Size of the firm (% distribution)		
Small	65	57.5
Medium	35	41.8
Large	-	.7
Nature of the business (% distribution)		
Agriculture,forestry and fishing	-	8
Mining and manufacturing	12	19
Transportation and public utilities	-	3
Wholesale trade	15	12
Retail trade	21	17
Finance, insurance and real estate	18	3
Services	23	20
Other	12	19
Cases where loan officer represents sole or lead banker (%)	82.4	98.6
Whether firm is owner-managed		
Yes (%)	94.1	93.2
No (%)	5.9	6.8

CHAPTER V

OBSERVATIONS: RECOGNITION OF PROBLEM LOANS

> "...the problem is that banks base their loan policy on the assumption that they will be able to identify a failing company and extract their loans before its asset value falls below the value of these loans. It is quite clear that, too often, they cannot".
>
> - John Argenti (1976b, p.185)

In this chapter, the main observations of the study pertaining to problem loan recognition are presented. The related issues dealing with the response of the banks will be dealt with in the next chapter. It is usually appropriate in an empirical research to report the "findings" of the study which involves presentation of the results followed by a discussion. However, as explained in the previous chapter, the present study is exploratory and involves quantitative and qualitative components. On some issues the two methods supplement and in others they complement each other. The intention is to identify relationships and observe patterns, not to test hypotheses. Therefore, rather than calling them findings, the word "observations" seems more appropriate.

The sections in this chapter each report a main observation and where appropriate, relate quantitative and qualitative support, look at it from the institutional perspective of the bank and that of the loan officer, and discuss its implications.

A. Problem Loans and Business Failures

This section deals with the definition of a problem loan from the point of view of a bank and loan officers and looks at its links with the notion of business failures.

1. Definitions

The banking literature views problem loans in a very general manner as any loan in which problems develop which adversely affect the bank's liquidity and increase the possibility of loss (Reed et al., 1984). In other words, by definition, a bank does not make a bad loan, but once a loan has been made, problems may develop which create a possibility of there being a loss of interest or principal, or both. While this could also occur due to the unwillingness of the borrower to repay, it is largely due to the inability to repay and it is this condition which concerns us.

Banks on their own and as required by regulatory authorities, have defined the problem loan, which is also referred to as a non-performing loan, in more operational terms. When a loan is recognized as having a problem, interest may continue to be charged or accrued, even though it may not be paid. When interest is no longer being charged, it is considered to be in non-accrual status. If the interest rate and terms of payment are renegotiated, the loan may be on a recovery list but is still considered non-performing when the renegotiated rate and terms are lower than what would be charged on a new fully performing loan of similar status.

From the point of view of sound banking principles and out of concern for public disclosure, the regulatory authorities in Canada (Office of the Superintendent of Financial Institutions), and in the US (Office of the Controller of Currency, Federal Reserve Bank, and the state banking regulators) further define rules and regulations for dealing with problem loans in terms of accounting and provision for reserves on the banks' books.

Non-performing loans and their consequences affect a bank's financial statements in several ways. As interest goes unpaid, revenues decline and as loan principal is written down, assets decline. Time spent on collection is diverted from business development. The effort of collection gives rise to other expenses as professionals are employed, third party costs incurred, etc.

2. Loan Officers Responses

In the questionnaire, an open-ended question specifically asked loan officers to "define a problem loan" and whether there are standard policies to deal with them.

A summary of their responses reveals that a problem loan is looked upon as one where:

a. there is a violation of the loan covenants in terms of dividends declared, assets acquired, reduction in security value, overdrafts, etc.

b. there is a delinquency, i.e. interest and/or principal have not been repaid as per plan, and

c. there is a decline in the financial performance of the firm revealed through declining ratios, weak cash flow, etc.

Each officer expressed different elements or combinations of these items. An analysis of the responses between the officers reveals an interesting distinction. Some of the loan officers, viewing the problem loan in purely financial terms, describe it as, "non-payment of interest and principal and violation of covenants", "delinquency, low profitability and reduced quality of security", "90 days overdue", etc. There are others who look at it from a more managerial point of view. They termed a problem loan as "any loan whose primary and secondary repayment sources are in actual or potential jeopardy", "where the client's repayment capacity has been jeopardized and/or where quality of underlying security has seriously deteriorated", "any account where there are factors negatively affecting a company's viability creates an atmosphere where an account or loan can be a problem".

In addition to the above, there is a distinction in their responses to the second part of the question regarding policies to deal with problem loans. While some feel that there are standard policies and guidelines, others recognize that "each case is different and you can't rigidly adhere to the policies".

3. Discussion

At the beginning of the literature review (Chapter II) a brief reference was made to research into the causes of decline. Miller (1977) stresses the need to distinguish between causes and symptoms of failure and Argenti (1976) argues that while the underlying causes lead to failure, focusing on and eliminating the symptoms (e.g. through financial ratios, cash for paying wages, etc.) may not prevent failure. A similar distinction appears in the loan officer's view of problem loans. The distinction between those who look upon it in purely financial terms and those who look upon it in a more managerial fashion is a replica of the distinction between looking at the symptoms and looking at the causes. Looking at the mechanics of payment and delinquency is concentrating on only the symptoms which appear at the surface while looking beyond at the health of the firm and the ability to pay is examining the causes.

During discussions with the bank officers, the importance of differentiating between the symptoms and the underlying problems came through quite clearly since they dictate the responses. The implications of this distinction will be discussed in a subsequent section.

B. Distinction Between Decline and Failure

While discussing the nature of decline in Chapter II, the need for distinguishing between decline and failure was established. This section reports on the view of the senior bankers on this distinction and also discusses the responses of the loan officers when asked about it.

1. The Rating System

The distinction between a decline in the financial performance of the client and impending failure is made by the bank with the help of a rating system. This is a method of categorizing the risk of a loan. It is undertaken when the loan is first made and a client could move between categories depending on the bank's on-going evaluation. The objective of the system is to protect banks' exposure and to initiate action to reduce exposure and commence turnaround of the client through early detection. A commercial bank's credit risk rating system is a method of classifying the risk of a loan and involves laying down the policy, definitions and procedures for guiding a loan officer/account manager in his/her credit analysis. The regulatory authorities provide broad guidelines for classifying risk. Appendix E provides extracts of the categories as designated by the regulators in the US and Canada. Banks further expand and develop on these guidelines to suit their policies.

The rating system of a bank is considered to be confidential information; it is neither exchanged between banks nor does a client get to know the rating category of his loan. On guaranteeing confidentiality, two banks in Canada and three in the US provided the researcher with copies of their rating systems. A third bank in Canada stated that it does not have one and only uses the broad guidelines of the regulatory authorities. The others declined to provide a copy on grounds of confidentiality but described their system during interviews.

The rating systems range from six to nine types of classification of the loans. The top rating would be for the clients of undoubted standing and the lowest for loans which are on non-accrual, where loss of interest and principal is expected and which are in the process of bankruptcy or liquidation. The rest of the categories are spread along a continuum of deteriorating quality. The extent of detail in the guidelines varies between banks and some have adapted their rating scales to suit particular sectors which dominate their operations, such as real estate, retail, etc.

Appendix F provides extracts of select categories from the rating systems of three banks. An analysis shows that these banks definitely make a distinction between decline and impending failure through their rating systems. In accompanying worksheets, each bank provides different criteria to enable classification of the loan. The criteria of Bank A include review of seven factors to be undertaken for a firm: financials, management, industry status, security, terms of support, account activity, and competitor actions. The criteria of Bank B cover four subject areas: management, money, materials, and markets. Each one is further broken into 13, 42, 16, and 12 items respectively to aid categorization.

A closer look at the "management" subject area in these criteria provides some insights. Though not specified as such in the list, they can be looked upon as covering four groups of issues, viz. strategic planning, operations, governance, and external reasons. In the case of Bank B, some of the items among the 13 listed are: possibility of inadequate performance due to lack of management depth in principal operating areas, possibility of adverse effect from lack of adequate organization structure, planning, policies, etc., possibility of change of control, possibility of inadequate labor supply, etc. A similar scrutiny of the questions listed under the "management" factor in the case of Bank A covers issues of quality, competence, depth, and stability. Statements provided in the worksheet against which the loan officers evaluate the standing of the firm include: lack of clear understanding of key leverage points in their business, over-reliance on a single product/ customer/ supplier/ market, untimely decisions into untried product lines, does management project a clear understanding of the financial issues/concerns they face, etc.

Broadly summarizing, the rating systems classify firms into categories which fall into three groups: a) good or acceptable credit risks, b) non-performing loans still believed recoverable, and c) non-accrual loans. There is usually a cut-off point where the firms are designated as problem loans and carry different rating numbers. Sometimes, before actual re-classification into a problem loan category, firms are briefly put on a "watch list" for closer observation and monitoring. Firms falling into the (b) category are believed to be in a stage where the problems are not yet severe and there is reasonable expectation of turnaround. The firm may or may not be incurring losses at this stage and the account may be either current or delinquent. Firms falling into the (c) category are the more severe cases where the bank is prepared for more drastic actions, is getting concerned about the recovery of its dues, and is preparing for a loss. Thus, the rating system apart from trying to differentiate between the severity of the problem, also makes some broad prescriptions about the response of the bank by tying the response to the category of risk. The significance of this distinction will be further developed under the subsequent section on responses.

The rating system also sometimes specifies the time frame for action in each category and specifies where the responsibility for further action lies within the bank; whether with the loan officer or at specialized functions within the bank, and at what stage the transfer to higher levels is mandatory.

2. Response of Loan Officers

As described above, the rating system is the mechanism by which banks classify clients depending on the severity of their condition. A description of the system gave an indication of how the bank differentiates between decline and impending failure and how it distinguishes between the severity of the problems facing its clients. This attempt to differentiate between decline and failure was further raised in the questionnaire, where loan officers were asked to describe the condition of the firm when it was classified as a problem loan. Table 5.1 summarizes the responses for US and Canada. The percentage of firms considered to be suffering from serious but not critical problems when classified as a problem loan was 35 among the US firms and 39 among the Canadian firms. The condition was considered to be a crisis threatening the survival of the firm in 56 percent of the US firms and 40 percent of the Canadian firms.

These responses indicate that, a) while classifying the firm as a `problem loan', the loan officer is able to make a distinction in the severity of the problems, b) the rating system permits such a distinction to be made, and c) the distinction enables a loan officer to differentiate between a situation of decline from a situation which threatens the survival of the firm.

During interviews, loan officers and senior bank officials agreed very strongly on the need to make the distinction between a decline in performance and an impending failure. Keeping in mind the bank's primary purpose of safeguarding its assets, the officers said that the distinction is made by looking at the severity of the problem in conjunction with the extent of security coverage and the judgement of the loan officer as to the clients ability to overcome the problems. This corresponds closely with the distinction between decline and impending failure. During a period of decline of financial performance but when the situation is still not severe, the existing collateral covers the bank's risk. When the severity accelerates, the security weakens and increases the exposure of the bank to undue risk.

3. Discussion

There are a few significant aspects of understanding which emerge from the above analysis of the bank's rating system and its use. In Section A the meaning of a problem loan was discussed and it was shown that loan officers could possibly view it either as a pure financial aberration or as a managerial problem by looking at the underlying causes for the problem. Formal rating systems try to incorporate the need to make an in-depth analysis of the firm in order to estimate the nature and severity of the problem. By providing a structure and set of guidelines, banks try to ensure that a loan is analyzed from an overall perspective. The use of a rating system is undertaken not only when a firm is undergoing problems. It is the basic framework of credit rating and analysis which is resorted to when first granting the loan to the client. The realization that the security and productivity of the loan is closely related to the basic health of the enterprise is translated by the bank into the monitoring system. As the extracts from the rating systems given in the appendix show, the financial condition of the firm can be satisfactory but it can still be considered a problem loan if there are other indications of potential risk.

The nature of credit risk analysis very closely resembles that of a strategic analysis of the firm. The components of the formalized systems examined above cover short-term and long-term aspects and transcend various functional areas. This is similar to the analysis recommended as an on-going activity for a firm from a strategic management perspective. For instance, Bank A, in the introduction to its guidelines, instructs loan officers that "the basic objective in the assessment process is to risk rate the borrower and not each facility although it is recognized situations do exist where individual credit segments of the same borrower carry different quality ratings". Thus, the loan officer is advised to view the firm as an overall entity and not just evaluate one segment, while undertaking the rating process.

It is important to note that the rating system incorporates financial and non-financial characteristics. There are areas which are judgmental (e.g. management), making it a very subjective process. In trying to recognize a problem loan early, categories in the rating system take account of the fact that it is potential risk that is being estimated. Even if the account is current (i.e. not delinquent) and there are no losses, there could be cause to indicate a potential risk. Thus, the `watch list' and the initial problem loan categories attempt to identify a problem loan and thereby a business failure at its incipient stages.

The extent of detail in the risk rating system of each bank would vary. One large bank in Canada follows the more generalized guidelines of the regulatory authorities and permits more latitude to the loan officers in classifying and reporting on their problem loans. They believe that a detailed rating system tends to make them risk averse. Other rating systems which were available reveal the same distinctions and basic premises as the one outlined above but in a less elaborate manner. The rating systems appear to go through their phase of evolution depending on the size of the bank, the frequency and extent of problem loans, the extent of automation within the bank, and the banks philosophy towards problem loans.

One of the research objectives stated in Chapter III was to see if banks made the distinction between decline and impending failure and the process by which it was made. This has been established in this section by describing the rating system and its application.

Several authors (Argenti, 1976; Hambrick & D'Aveni, 1988; Weitzel & Jonsson, 1989) have described stages of decline and different trajectories of decline which were reviewed earlier. The approach of distinguishing between different stages of decline finds strong support when viewed at from the perspective of the bank too.

C. Recognition of the Problem

The previous section described the rating system of categorization as an early means of recognizing a business failure. Empirical researchers who have developed models for prediction of failure have relied almost exclusively on accounting ratios and financial trends (Altman, 1983). A bank's system of classification based as it is on not only trend analysis of financial indicators but on other strategic and operational factors too can be looked upon as an additional important index available to the firm. In this section, the further role of the bank as an early trigger for recognition is discussed, as also the role of the loan officer and the cues used for recognition.

1. The Importance of Recognition

An early recognition of a problem loan is considered to be an important issue in a bank's credit policy and loan monitoring system. A Senior Vice President of a Canadian bank referred to a recent letter issued to senior lending officers in which they were told that "to have a problem loan is not a sin but not to recognize it is unforgivable". Banking lore reiterates that "Nobody makes a bad loan; it's a good loan that goes bad". While this may be questionable (some bankers did admit to a small fraction of the bad loans being due to over-zealousness on the part of the bank) bankers realize that in the course of normal business, problem loans do occur. Lack of problem loans could even indicate an excessively conservative approach to lending and missed business opportunities. What is important for the bank is to be able to identify early enough a loan turning bad and fixing it.

Banks attempt to pick up the signals of a problem loan through an ongoing analyis of the financial and operating activities of the company, evaluation of the management, and an awareness of the environment. In this function, the lending officer is looked upon as the first line of defense, and an important link between the bank and the client firm.

2. Recognition by the Loan Officer

The onus is primarily on the loan officer (called account manager in some banks) to warn the bank of potential problems with loans. The rating system discussed earlier is only a set of guidelines; its implementation and interpretation is left to the loan officer along with appropriate supervision. Most of the categories in the rating system also call for considerable subjective judgement on the part of the loan officer.

In the course of interviews with loan officers, they mentioned that the financial reports received from the clients were important but only a subset of the cues used to identify a problem loan. They rely on field visits, market reports, etc., a mixture of financial and non-financial indicators. To better understand the indicators of a problem loan, the questionnaire specifically asked the loan officers "what were the main cues used to identify this client as a problem loan". They rated the cues on a 5-point interval scale ranging from 1 (very important) to 5 (unimportant). Table 5.2 lists the 18 cues along with the mean and standard deviation for the US and Canadian samples. The correlation among the cues are reported in Tables 5.3 and 5.4 for US and Canada respectively. Tables 5.3a and 5.4a adapt the same information to highlight the significant values.

Judging by the mean values, `declining profit trends' and `inadequate cash flow' are considered the most important among all the cues in both the samples. However, testing the difference between the two samples using a t-test, `declining profits trend' is considered significantly higher in the US than in Canada ($p<.05$). The other variables on which significant differences are observed include `occurrence of overdrafts' (more important in Canada, $p<.01$), and `delinquency or slow loan payments' (more important in the US, $p<.05$).

It is interesting that delinquency is relatively less important than declining profit trend and inadequate cash flow as a cue. In banking terminology, problem loans are often defined using delinquency of 30, 60, or 90 days as cut-off points for re-classification of the loan. When asked to define a problem loan, loan officers had frequently included delinquency as one of the characteristics. However, in rating it lower as a cue, loan officers are recognizing the fact that inadequate cash flow and declining profit trends can occur before a loan becomes overdue. By looking at other indicators loan officers obtain earlier signals for identifying a problem loan before another function/department within the bank, such as loan review or the credit department, which would pick up the signals through the internal information systems which monitor delinquency, overdrafts, and security coverage.

The low importance of `audit report qualification' can be explained by the fact that as almost all the firms were small to medium in size, they may not have regular external audit checks.

Some of the other financial indicators such as `deteriorating receivables', `inventory turnover', and `extended trade payables' while being correlated (Tables 5.3 and 5.4) are rated lower in importance than the more straightforward indicators such as `deviation of performance from plan' and `declining sales trends'. The lower importance of certain management changes such as `changes in accountants' and `changes in executives/ stockholders' differs from the view held in the literature that management turnover is an early indicator in the decline phase. The reason for this could again be that given the small to medium size of the firms, these cues do not appear as significant.

`Declining profits trend', an obvious warning signal also used in failure prediction models, is strongly correlated with `financial ratios' and `inadequate cash flow'. The `occurrence of overdrafts', more important in

Canada, also shows strong correlation with operational cues such as poor cash flow, payable/receivable problems, and delayed submission of statements to the bank.

Loan officers mentioned during interviews that `delayed receipt of statements' and `reluctance to share information with the bank' are events which occur frequently when the firm is in difficulty. They, however, do not appear to be very important cues on their own and would be effective only in conjunction with others.

3. Other Related Issues

Some of the other issues which emerged during the interviews in connection with the role loan officers play in recognition of problem loans are noteworthy.

a. Loan Officer - Client Relations. The Canadian bankers mentioned that due to the branch banking system, there was a tendency to transfer loan officers between branches, every three to five years. With more limited dispersal of operations in the US system, transfer is a rare occurence. This results in loan officers staying with a given portfolio much longer in the US than in Canada. The repercussions for loan recognition are that often loan officers in the US can get to know their clients better and have longer term relations with them than Canadian officers. In analyzing the rating systems of the banks, it appears that the Canadian banks apparently have more elaborate systems for recognizing problem loans than the American banks. It is possible that this could partly compensate for the more frequent personnel transfers in Canada.

A risk in establishing long-term relations with the client is seen by the banks as getting too close to them and identifying with the client rather than with the bank. This view was expressed both by senior officials and loan officers. Loan officers feel the need to maintain a distance to be able to take a dispassionate view. However, understanding the client closely is viewed by one loan officer as helping to "avoid your problems by being in the front end of the train [rather] than the back end. It takes five years to get that close to a client. And that's when you really start contributing to that business..then you get involved in their succession planning". While loan officers are expected to be close to their clients from a business development perspective, it is viewed as a disqualification when the client turns into a problem loan. Resolution of this conflict is sometimes achieved through supervision of the loan officer and described under paragraph (d) below.

b. Age and Experience. Senior officials of the banks mentioned that increasingly younger individuals with more academic qualification than experience are occupying positions as loan officers. Their judgement is that this tends to make the officers more reliant on reports and financial information, and lowers their credibility in the eyes of the client in accepting the loan officers' suggestions and concerns. The profile of the loan officers in this study does not show any difference between the two samples in years of experience or number of problem loans handled (Table 4.1).

c. Supervision and Support Systems. To take into account the need for supervision of the loan officers efforts at recognition, banks develop checks and support systems. The bank's systems and procedures stipulate trip-wires to aid early recognition and provide a fall-back. The methods include:

i) Having rating systems which provide for mandatory re-classifications at various levels of deterioration. While there is still an element of judgement with the loan officer, depending on the extent of delinquency or a time frame from initial identification, mandatory re-classifications of the problem loan to higher risk categories are provided.

ii) Handing over of the account to the workout department at a cut-off point in the classification sequence. Beyond a stage in the rating sequence, some banks require the loan officer to withdraw from primary decision making on the handling of the problem loan which is taken over by senior levels in the hierarchy, or specialized departments such as workout or loan review.

iii) Requiring reports from the loan officer on action taken even prior to re-classification and specifying a time period within which improvement would take place. Even while holding exclusive charge, the loan officer may be required to justify to the supervisory function the steps being taken to workout the problem and why re-classification is not yet required.

iv) Independent scrutiny by other departments within the bank. Other departments such as loan review, credit, etc. scrutinize overdrafts, covenant violations, and delinquency and could initiate a request to the concerned loan officer to justify the current rating.

Loan officers too recognize this pressure and realize that there is a supervision of the problem loan recognition process.

4. Recognition by the Client and Use of Shocks

While in a predominant number of cases the bank was the first to raise the concern about declining performance with the client, in a small number of cases (6% in the US and 12.6% in Canada) the officers reported that the client recognized his problems first and voluntarily notified the bank. In 32 percent of the cases in both the US and Canada there was an initial denial by the client when the bank revealed its concern. During interviews too the officers remarked that an initial denial by the client is common.

The process model on recognition in Chapter III described the possibility of the banks "precipitating" a crisis in the firm by using its financial leverage to shock the client into seeing its point of view. A question addressed to the loan officers asked whether the bank had to `shock the client into recognizing the situation as a crisis (e.g. additional credit being made conditional to changes, etc.)'. In 47.1 percent of the cases in the US and 51 percent of the cases in Canada, the loan officers answered `yes'. This, in a way, supports the commonly held view in the literature that incumbent management often denies the existence of a problem until the situation deteriorates to a point when it is either obvious or management is forced to admit that the problem is more severe than previously believed. One senior bank official remarked, "..a lot of the clients are not prepared to accept that they have a problem....when we look at a situation and think the business is deteriorating, the first way out as far as I'm concerned is to tell the fellow he has got a serious problem and if he doesn't agree with you to tell him he has got to find another financier."

When the responses on recognition and the need for shock are tabulated jointly (Table 5.5) the picture shows that where there is acceptance by the client there is less of a need to shock in both the samples. Even when there is acceptance, the need to shock could arise because of the close connection between recognition and response to the problem. While they are being treated separately here for the purpose of discussion, the bank would expect to see action simultaneous with an admission of problems. Therefore, the need to `shock' the client does not have an exact correspondence with initial acceptance or denial of the problems.

5. Discussion

Experimental studies have been conducted in the accounting field (Libby, 1975; Abdel-Khalik and El-Sheshai, 1980; Casey, 1980) to examine the ability of bank loan officers to predict corporate failure using financial ratios. Libby found that bank loan officers used financial ratios to predict corporate failure for sample firms with 74 percent accuracy. However, Casey, in replicating Libby's study with slight variations in design, found that the ability of loan officers to predict corporate failure accurately based on accounting ratios alone may not be generalizable. This view was further extended in the Abdel-Khalik and El-Sheshai study which concluded that loan officers performed worse than the mechanical failure prediction models used to generate various benchmarks to aid prediction.

The data in the current study point to reasons for the weakness in the conclusions of the above experiments. It seems quite clear that the loan officers depend on several cues to identify a problem and not accounting or financial ratios alone. Keasey and Watson (1987) in a study using data on 73 failed and 73 non-failed companies argue that marginally better predictions concerning small company failure may be obtained from non-financial data as compared to those which can be achieved from using traditional financial ratios. While the financial ratios are a significant element in the information processing model of the loan officers, they are used in combination with non-financial and operating indicators such as declining sales trend, occurrence of overdrafts, etc. Moreover, the objective of the accounting studies has been to arrive at a `yes/no' decision of the possibility of failure or bankruptcy. This is not the way loan officers operate. While one of the main considerations of the officers is to estimate the ultimate threat to the security of the banks funds at risk, they are able to distinguish between levels of severity of the problem facing the client. Hence the process is a dynamic one and should be borne in mind while estimating static data. Once the emerging problem is identified, different combinations of these cues would be used at different points of time for the same firm to arrive at varying estimates of the severity of the problem. They are not sequential indicators.

This chapter further establishes the important role of the bank as an external trigger for the recognition of the problem in a client. When there is a denial on the part of the client, the bank is not above resorting to shocks to bring about the recognition by making it conditional for further assistance or using the threat of withdrawal from the relationship. The importance of this role is derived from the close correspondence between the interests of the firm and that of the bank in the event of early recognition. On the face of it, the figures in Table 5.1 could be interpreted to mean that in 56 percent of the firms in the US and 40 percent in Canada, the problems were not recognized early enough but only when they threatened the survival of the firm. However, this interpretation would be misleading because, as would be shown subsequently, the loan officers do not classify a firm as a problem loan immediately on suspicion of a problem. There is a lag in classification. Moreover, since not all firms deteriorate gradually, there could be a rapid movement into failure soon after identification.

Just as an early recognition of the problems of a firm can lead to easier and more successful turnaround efforts, the bank's interest in early recognition stems from its concern for the safety of its assets from a long term point of view. Although financially a loan may be secured sufficiently for a bank not to have serious concerns, the possibility of deterioration affecting the security is sufficient cause for the bank's interest in an early recognition.

The next chapter will extend this discussion of problem loan recognition by incorporating the issues pertaining to the response strategies of the banks.

Table 5.1

Condition of Firms When
Classified as a Problem Loan

Item	U.S %	Canada %
Problems were of a temporary nature which could be tackled	8.8	21.4
Problems were serious causing a decline in financial performance but not critical	35.3	38.6
The firm was in a crisis which threatened its survival	55.9	40.0
Total	100	100

Table 5.2

Cues Used to Identify a Problem Loan

ITEM	US		Canada		
	Mean	s.d.	Mean	s.d.	t
1. Analysis of financial ratios	2.32	1.22	2.31	1.3	
2. Deviation of performance from plan	2.65	1.33	2.47	1.31	
3. Declining sales trend	2.75	1.48	2.54	1.44	
4. Declining profits trend	1.27	0.76	1.61	1.04	*
5. Inadequate cash flow	1.56	1.13	1.51	0.83	
6. Deteriorating receivables	3.12	1.6	3.13	1.52	
7. Slow inventory turnover	3.19	1.4	3.27	1.51	
8. Extended trade payables	2.69	1.42	2.78	1.37	
9. Change in accountants'	4.07	1.11	4.4	1.02	
10. Change in key stockholders and executives	3.87	1.41	4.15	1.38	
11. Credit inquiries from trade	3.97	1.05	3.88	1.23	
12. Problems of the industry	3.19	1.42	3.43	1.47	
13. Personal factors	3.81	1.49	4.31	1.23	
14. Delayed submission of financial statements	2.58	1.35	3.07	1.52	
15. Reluctance to share information with the bank	3.13	1.59	3.22	1.55	
16. Occurrence of overdrafts	3.5	1.65	2.51	1.59	**
17. Delinquent or slow payments	2.53	1.7	3.27	1.68	*
18. Qualification in the audit report	4.23	1.22	4.21	1.2	

* $p \leq 5$
** $p \leq .01$

Table 5.3

Correlation of Cues - US

ITEM	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18
1.Financial Ratios	1.0																	
2.Deviation:Perf/plan	13	1.0																
3.Dec Sales Trend	-15	41*	1.0															
4.Dec Profits Trend	46**	20	12	1.0														
5.Inad Cash Flow	12	07	17	59**	1.0													
6.Deter receivables	-25	30	49**	13	14	1.0												
7.Slow invent turn	-12	29	46**	13	-18	46**	1.0											
8.Extend trade payab	-12	22	15	17	35*	48**	33	1.0										
9.Chg in accountants	-14	18	02	16	33	20	40*	37*	1.0									
10.Chg in execs/stkhld	07	39*	27	19	13	12	13	00	-10	1.0								
11.Credit inq from trd	06	16	17	09	27	-02	00	38*	-02	56**	1.0							
12.Probs of inds	-18	10	39 *	19	03	09	29	-11	-07	52**	29	1.0						
13.Personal factors	-20	-05	-15	-41 *	-22	-04	-08	09	10	07	15	-04	1.0					
14.Delays in statement	09	-09	-02	05	03	13	23	32	15	07	30	-04	20	1.0				
15.Reluct to share inf	-09	21	03	-08	03	16	20	06	47**	07	00	-01	35	63**	1.0			
16.Occurrence of OD	-30	24	40 *	18	26	48**	39*	32	41 *	19	17	17	10	23	51	1.0		
17.Delinquency/Slow pay	-20	06	35	-08	09	43 *	13	04	28	12	-03	11	18	12	54**	55**	1.0	
18.Qualif in audit rep	-23	09	10	07	16	42 *	26	25	49**	22	30	22	37 *	23	53**	54**	48**	1.0

* $p \leq .05$, two tailed test

** $p \leq .01$

Continued, next page.

Table 5.3a (cont.)

(Significance Highlighted)

ITEM	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18
1.Financial Ratios	1.0																	
2.Deviation:Perf/plan	.	1.0																
3.Dec Sales Trend	.	*	1.0															
4.Dec Profits Trend	**			1.0														
5 Inad Cash Flow	.			**	1.0													
6 Deter receivables		.	**	.	.	1.0												
7 Slow invent turn			**	.		**	1.0											
8 Extend trade payab		.	.	.	*	**		1.0										
9 Chg in accountants		.	.				*	*	1.0									
10 Chg in execs/stkhld		*		.	.				.	1.0								
11 Credit inq from trd			.	.	.			*		**	1.0							
12 Probs of inds		.	*	.		.				**		1.0						
13 Personal factors	.	.	.	*	.	.					.	.	1.0					
14 Delays in statement	.	.	.	.	.	.	.	.		.	.	.	.	1.0				
15 Reluct to share inf	.	.	.	.	.	.	.		**	.	.	.		**	1.0			
16 Occurrence of OD	.	.	*	.	.	**	*		*	.	.	.	.	.	.	1.0		
17 Delinquency/Slow pay	.	.	.	.	.	*	.	.	.	.	.	.	.	.	**	**	1.0	
18 Qualif in audit rep	.	.	.	.	.	*	.	.	**	.	.	.	*	.	**	**	**	1.0

* $p \leq .05$, two tailed test

** $p \leq .01$

Table 5.4

Correlation of Cues - Canada

ITEM	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18
1.Financial Ratios	1.0																	
2.Deviation:Perf/plan	24**	1.0																
3.Dec Sales Trend	20 *	34**	1.0															
4.Dec Profits Trend	34**	24**	38**	1.0														
5.Inad Cash Flow	05	23**	17	34**	1.0													
6.Deter receivables	11	18 *	27**	09	17 *	1.0												
7.Slow invent turn	12	06	29**	10	-01	41**	1.0											
8.Extend trade payab	08	12	18	15	22 *	50**	42**	1.0										
9.Chg in accountants	08	10	09	05	13	25**	10	20 *	1.0									
10.Chg in execs/stkhld	-08	11	04	-02	03	15	14	16	35**	1.0								
11.Credit inq from trd	-03	21 *	06	06	25**	31**	20 *	55**	25**	22**	1.0							
12.Probs of inds	09	03	09	05	06	15	27**	08	08	09	18 *	1.0						
13.Personal factors	-03	09	12	00	12	14	14	08	15	23**	15	03	1.0					
14.Delays in statement	-09	04	06	13	26**	24**	21 *	32**	14	15	32**	22 *	29**	1.0				
15.Reluct to share inf	-10	06	00	08	27**	20 *	-01	16	08	01	29**	11	20 *	60**	1.0			
16.Occurrence of OD	01	08	18 *	02	25**	35**	17	37**	12	13	34**	-11	12	40**	29**	1.0		
17.Delinquency/Slow pay	-03	07	21 *	-03	23**	16	21 *	16	18 *	15	19 *	04	31**	26**	32**	49**	1.0	
18.Qualif in audit rep	-03	04	-01	-01	13	06	02	07	23**	18 *	12	14	22 *	10	29**	09	19 *	1.0

* $p \leq .05$, two tailed test

** $p \leq .01$

Continued, next page.

Table 5.4a (cont.)

(Significance Highlighted)

ITEM	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18
1.Financial Ratios	1.0																	
2.Deviation:Perf/plan	**	1.0																
3.Dec Sales Trend	*	**	1.0															
4.Dec Profits Trend	**	**	**	1.0														
5.Inad Cash Flow	.	**	.	**	1.0													
6.Deter receivables	.	*	**	.	*	1.0												
7.Slow invent turn	.	.	**	.	.	**	1.0											
8.Extend trade payab	.	.	.	.	*	**	**	1.0										
9.Chg in accountants	.	.	.	.	.	**	.	*	1.0									
10.Chg in execs/stkhld	.	.	.	.	.	.	.	.	**	1.0								
11.Credit inq from trd	.	*	.	.	**	**	*	**	**	**	1.0							
12.Probs of inds	.	.	.	.	.	.	**	.	.	.	*	1.0						
13.Personal factors	.	.	.	.	.	.	.	.	.	**	.	.	1.0					
14.Delays in statement	.	.	.	.	**	**	*	**	.	.	**	*	**	1.0				
15.Reluct to share inf	.	.	.	.	**	*	.	.	.	.	**	.	*	**	1.0			
16.Occurrence of OD	.	.	*	.	**	**	.	**	.	.	**	.	.	**	**	1.0		
17.Delinquency/Slow pay	.	.	*	.	**	.	*	.	*	.	*	.	**	**	**	**	1.0	
18.Qualif in audit rep	.	.	.	.	.	.	.	.	**	*	.	.	*	.	**	.	*	1.0

* $p \leq .05$, two tailed test

** $p \leq .01$

TABLE 5.5

Recognition: Acceptance or Denial and Use of Shock

ITEM	US (%)			Canada (%)		
	Had to shock		Row	Had to shock		Row
	Yes	No	Total	Yes	No	Total
Acceptance by client	28.6	71.4	61.8	35.4	64.6	55.2
Denial by client	90.9	9.1	32.4	91.3	8.7	32.2
Client initiates	0	100	5.9	16.7	83.3	12.6
Total	47.1	52.9	100	51.0	49.0	100

CHAPTER VI

OBSERVATIONS: RESPONSE

> "The trigger for change during a severe crisis is more likely to be an intervention from an outside source, most commonly banks or lending institutions, than management itself."
> - Stuart Slatter (1984, p.75)

The previous chapter examined issues connected with a bank recognizing a business failure and triggering that recognition in the client through its approach of identifying a problem loan. A simultaneous activity for a bank, along with recognition, is responding to the problem loan. In this chapter, the array of possible responses of the bank are presented, these are related to the causes of decline in the firm, and a model is put together to explain the response strategies.

A. Response of the Bank

The process of recognition explained in the previous chapter is further extended in this section in relation to the response of the loan officer and the bank to the problem loan.

1. The Process of Response

The objective of the bank in responding to a problem loan is what the senior bank officials often describe as "enlightened self-interest". At policy making levels, the bankers unanimously believe that the workout of a problem loan is preferable to forcing a liquidation. By `workout' is meant the efforts of a bank in working with the client to overcome the problems with the loan. Thus, it is a part of the turnaround strategy of the firm approached from the banks perspective. In the words of one banker, "we'd rather create survivors than casualties". Moreover, one Vice President remarked that "it is far more efficient financially and from a public relations point of view to help a client turn the corner than basically try and liquidate them".

The rating systems used by the bank for recognition of a problem loan sometimes build-in response strategies. One bank in Canada has a chart of 15 codes designating different alternatives or stages in their response to the problem. These include liquidation, debt restructuring with or without concessions, etc. They are all financial in nature and are codes that the bank attaches to its credit risk rating code to signify the response strategy being followed at each stage of the problem loan. Linking the response objectives with early recognition, another Canadian bank, in a handout to loan officers describing their Risk Assessment Process says, "Clearly, our ability to either reduce exposure, or work with a customer successfully to achieve a turnaround is greatly enhanced by early detection of account deterioration".

Generally, recognizing that each situation is different, banks attempt to build systems and lay down policies as broad guidelines, while monitoring progress individually within the bank. There is an on-going debate in the banking circles about the most appropriate method of dealing with the problem loans. There are two broad alternatives: one is to leave the response and workout efforts with the loan officer, and the other is to have a specialized loan workout function within the bank. Banks sometimes try out one approach after the other, and one sees both small and large banks following either approaches or combinations of the two.

The arguments, briefly, for and against either approaches are as below. In favor of letting the lending officer handle the workout is the belief that, a) the lending officer is responsible for making the loan and therefore should be responsible for cleaning the mess, b) he/she best understands the client's needs, and c) it is a part of the learning experience and helps the loan officer to avoid similar problems in other situations. In favor of setting up specialized departments for workout are, a) the lending officer is too close to the client to be able to view the problem objectively, b) there is a need for specialized expertise to handle workout, and c) it takes too much of the time of a lending officer affecting other areas of his/her operations.

Some banks have moved from relying on a lending officer exclusively to setting up workout departments, as they have grown and as the quantum of problem loans handled have increased. Others have set up specialized workout teams when the problems in one particular industry worsen and then disband the groups as the situation improves. Most adopt a combination of the two approaches by relying on the loan officer in the early stages of the problem, and then transferring the loan to a workout department depending on the time already taken on the loan, extent of severity of the decline, extent of the banks exposure, etc. Two of the banks had a time limit of six months after which, if the problems are either not resolved or are not progressing satisfactorily, the account's transfer to the workout department is mandatory. Even while the loan is being handled by the loan officer, regular progress reports are required within the bank wherein the loan officer would have to justify the strategy for resolution that is being followed and commit himself to a timetable.

The loan officers were asked about their position in the workout process at the time of responding to the questions. Table 6.1 summarizes the results. In 91.2 percent of the US cases and 87.6 percent of the Canadian cases the loan officer is handling the problem loan with or without the assistance of other departments. Even within this, the bulk of the cases are being handled exclusively by the loan officer with a significantly higher percentage in Canada than in the US (71% and 50% respectively). In 2.9 percent of the US cases and 4.1% of the Canadian cases the loan had been transferred to the workout department. However, even in those situations where the loan is transferred to the workout function, the loan officer is often kept in the picture as the administrative conduit for liaison and information though decision making does not rest with her.

In responding to a problem loan, some banks expressed concern about the need to resist the temptation to advise the clients on how to run their business. Senior officials and loan officers often hastened to add that while their function required them to alert the client and the bank to potential problems, they constantly have to bear in mind that they are not the experts in running the firm. "We are not financial advisers," said one. "The idea of small branch managers counselling people I find quite ludicrous. Most of us have a tough time with our own." Another senior official remarked, "We don't really feel ourselves especially competent to say to a customer that he should broaden his product line. We can only say we perceive a problem and he should seek specialized help." Another officer, head of the Workout Department, related his bank's approach to workout as, "What we try to do is to get the company to help itself by trying to position them to recognize deficiencies. We try to create self-awareness." However, at the level of the loan officer, it does appear to be difficult to maintain the distinction between serving as a warning bell and being an adviser or a manager. Many loan officers talked about trying not to be too closely involved, but while giving specific examples to illustrate a point, one could see that they often do advise or get drawn in, however obliquely. This is also observed in their responses as to how they visualize their role, which is presented in the next section.

Just as the onus for identification of a problem loan rests with the loan officers, so also does the initial response. An analysis of the discussions with the bankers actually reveals that it is more meaningful to talk about levels of responses rather than the response of the bank. One senior official remarked that the bank's objective as an institution which is expected to be followed by the impersonal workout department is capital preservation while that of a loan officer also involves preservation of a relationship. Moreover, the graded rating system results in the firm being at a more severe stage of decline when the account is transferred to the workout department. This has corresponding implications for recovery of funds and will, in itself, dictate variations in the response of the bank. Thus, it is important to examine the response of the loan officer more closely and differentiate it from the bank's response.

2. Loan Officer's Response

The loan officers response to the problem loan is examined in terms of their objectives, the distinction between decline and failure, and the lags in classification.

a. Objectives. The loan officers see their objective in a problem loan situation as trying to help the client while protecting the bank's interest. The responses to the question, "In addition to your primary objective in protecting the bank's funds, do you visualize your role as including the following" are listed in Table 6.2. The officers in the US and Canada consider it as `very important' their role to provide an early warning to a firm of an impending crisis (90.5% and 82.1%, US and Candian officers respectively), and to help the client, to the extent possible, in overcoming the problems (82.6% and 78.8% in the US and Canada respectively). Almost all of the remaining felt it is `somewhat important' to do so. Except for an insignificant number in the Canadian sample, nobody thought it is `unimportant'.

Apart from the above, loan officers were asked if there were any other roles they visualize. Judging from the response, many of them visualize their roles as being more active than their bank's policies would expect them to be. Some of the comments are: "improve management of operations", "provide financial advise", "assist client in considering possible complimentary areas of diversification", "identify with the client the potential sources of difficulty and the possible solutions", "analyze and recommend actions to take", etc. In addition to the immediate financial and operating interests of the client firms, some of the officers felt it important that they "protect trade creditors", "protect guarantors and investors", etc. This supports our argument in the previous section that while banks would ideally like to play a limited and distanced role, the loan officers see themselves in a more active light.

b. Decline vs Failure. An open-ended question queried the loan officers whether they "distinguish between decline in the financial performance of the firm (including losses) and the client's survival being threatened", in formulating their response to the problem loan. The answer was overwhelmingly in the affirmative. In clarifying how the distinction is made, some very interesting views and patterns emerged.

Only a very few view the distinction in purely financial terms, such as the "ability to absorb the impact of loss via equity", or "the stability of the balance sheet". The majority of the responses include one or more of the following types of comments as helping to distinguish between decline and impending failure:

i. The degree and severity of the decline or negative developments need to be considered. If the decline is significant and on going, survival can be threatened.

ii. Loss is only the symptom and not the problem. Losses or negative financial performance do not necessarily mean the company is in trouble. Magnitude of the losses in terms of long term viability needs to be evaluated.

iii. The causes for the decline and the potential for improvement needs to be evaluated. It needs to be determined whether management or external reasons like market, or events beyond their control are causing the decline.

iv. The risk rating system helps to distinguish between a loan which may be a problem loan but survival is not questioned and the next category where survival is questionable and the loan needs to be restructured.

v. Managements' ability to control and turnaround the problems. Good management can turn it around. Managements' understanding of the problems and the actions taken are key.

The above represents a grouping of the kinds of comments made by the loan officers and reveals that just as in the definition of a problem loan, many view their response as going beyond financial reasons and strategies. As required by the bank rating systems, officers are able to look beyond the immediate problems and perceive a difference between symptoms and causes of the problem and the managerial aspects of the crisis.

c. Criteria for Responses. During discussions, the loan officers frequently expanded on their role in handling a problem loan and referred to elements of the situation which influence their response.

The primary element that loan officers frequently say they look for is the extent of trust or cooperation exhibited by the client. Is the firm being honest and open, or trying to conceal information? As one loan officer put it, "If you are going to go through bad times with somebody, you've got to really trust them...so I would tend to tighten up based on a character reading very quickly on our controls. Whereas, if somebody is very forthright and up-front, I'll give him a longer leash. Knowing they are going to tell me before when I'm in trouble." While most often the initial reaction of the firm is to deny a problem, as noted earlier, subsequently there is a fair amount of acquiescence. In situations where the client voluntarily recognizes the problem and approaches the bank with the information about impending problems and a tentative action plan, the officers feel that they are more accommodating than if they have to indulge in arm-twisting to get the client to act.

Very similar to this issue of first being able to trust the management is the judgement of the management's ability to turnaround the firm. The question of judging management and how rating systems approach it was commented upon in the earlier chapter discussing recognition. Admitting that it is a very subjective decision, banks evaluate the plans/strategy of the firm to turnaround, along with their confidence in the management's ability to achieve the results. As the Executive Vice President of a large Canadian bank said bluntly, "It is an arbitrary judgement which we have to make whether we restructure and go on or we liquidate. And it is fundamentally a judgement on management."

Trying to shock the client into recognizing his problems was mentioned earlier. By extension, banks resort to this approach also to influence the client into taking action. Measures such as refusing a line of credit, asking the client to find another banker, shifting the loan from the loan officer to a workout department, etc. are ways of prodding the client along a path acceptable to the bank.

d. Lags in Classification. In order to judge the nature of any lags in the process of classification, the loan officers were asked to estimate the time taken, i) between when the problem was identified and the firm classified as a problem loan, and ii) between when the problem was identified and the client informed of the banks concern (Table 6.3). While there is a lag of about 11 weeks between identification and classification, it is only about 3 to 4 weeks before the client is informed of the banks concern. The difference between the two, namely, about 7 to 8 weeks can be interpreted as the period when the loan officer is bringing about the recognition and is simultaneously influencing the client to respond with an appropriate plan. This occurs <u>even before</u> the bank "officially" steps in with a change in the risk classification and would be a very early warning to a client firm.

The lag in classification lends further credence to the belief that the response of the bank can be seen to operate at two levels. The loan officer on whom the bank depends for early recognition of a problem loan has a first attempt at assisting the client to recognize the problem and initiate attempts at turnaround. Due to established links, he/she is able to advise and assist, and sees his/her role in a larger light than the bank's official role would prescribe. If these attempts do not succeed, or even if they are in the process of resolution, the procedure works to get the loan re-classified onto a higher risk rating. This would trigger further safeguards from the bank's point of view and give the loan the necessary status for more concerted effort from the bank at an institutional level.

3. Response Variables and Strategies

In order to understand the array of responses available for use by the loan officer, they were asked to designate, on a 5-point scale ranging from 1 (under active consideration/implementation) to 5 (will not be considered), the status of 22 possible types of intervention for the specific problem loans being reported on. The variables are listed in Table 6.4 along with their mean and standard deviation.

Among the response variables, those more likely to be considered or resorted to are `seeking additional collateral for existing loans', `seeking guarantees in addition to existing collateral', `time extension of the due date of the debt', `recommend additional capitalization', `recommend downsizing business/asset divestment', `suggest improvements in operations/cost reductions', and `recall of loan'.

A comparison of the means shows that some of the options such as `part forgiveness of the loan', `sale of loan', `settle out of court with interest and principal loss', and `exchange of debt for equity' are not usually active options. While banking literature considers part forgiveness as an option, like settling out of court, some of these responses would perhaps be considered at later stages in the workout process; it must be borne in mind that these are being considered by the loan officer on behalf of the bank while he/she is still handling the loan. While sale of the loan to another bank is mentioned in the banking literature as an option and is also specifically considered in the rating system of one bank, loan officers admitted to the difficulty of using it since it is difficult to time the sale such that the loan would still be attractive to another bank. Exchanging debt for equity is an option used more readily in the case of large publicly traded firms and not for the size of firms being reported on here, and is again a decision taken at higher levels and at later stages of the workout.

Bankers at different levels mentioned during the interviews that due to concerns of lender liability, they are reluctant to initiate a change in management or act in a manner that could be interpreted as exercising control over the client. However, they do make suggestions and indirect recommendations, often working through a consultant. One senior vice-president in charge of workout commented, "Indirectly you suggest a plan and alternatives. You would always make it clear that the client was making the decision." The loan officers, working at a more informal level in the initial stages, are less inhibited in their actions.

It is important to mention here that these response variables are not strictly alternatives but are often viewed as concurrent or sequential measures. The scale measuring the replies were designed to take this characteristic into account with the choice being labeled as `likely to be considered/resorted to', `neutral-may or may not be considered', etc. This has a bearing particularly in the subsequent analyses in which these variables are to be used.

Significant differences between the US and Canadian samples exist in three variables. While the US loan officers are more inclined to granting extension of time on the due date of the debt, they are also more inclined to recover the money through legal measures. There are also differences on sale of the loan as a strategy, but the mean of the variable does not make it an important one for consideration. The two samples had differing correlation structures, which are reported in Tables 6.5 and 6.6 for US and Canada respectively. (Tables 6.5a and 6.6a highlight the significant correlations for US and Canada respectively.)

Seeking additional collateral as a response correlates well with requiring additional capitalization, recommending downsizing, and recommending merger/sale of the unit in Canada but not in the US. Granting of additional loans, though, correlates well with additional capitalization and suggesting improvements in operations in both samples. Granting extension of time, which has more importance in the US than in Canada, correlates well with recommending a consultant in the US but not in Canada. Generally, in the Canadian sample, the managerial responses such as recommending consultants, recommending management changes, and systems improvements correlates strongly with each other as against the US sample.

Thus, the Canadian loan officers appear more willing to use consultants along with other approaches and seem to have a broader span of managerial responses as part of their package than the US officers, especially managerial changes. Even in the case of financial strategies, the Canadian loan officers, in addition to additional collateral and guarantees go in for additional capitalization, and structural changes such as downsizing and mergers.

In order to examine if these variables group along definite factors, a factor analysis (principal components using Kaiser normalization) was performed with varimax rotation. The results for the US and Canadian samples are listed under Tables 6.7 and 6.8 respectively.

Seven factors emerged in each of the samples explaining 79 percent of the variance in the US and 69.3 percent in the Canadian cases. The factor loadings are strong. It is interesting that the most important factors explaining 22 percent and 24.3 percent in the Canadian and US samples respectively are workout related variables. This supports the views expressed by the officers that their first preference is always for a workout. Studying the first factor in each sample, the Canadian factor is seen to be managerial in its approach involving managerial and strategy changes, systems and operations improvements, and recommending a consultant. The US factor is more financial with a bias towards reducing exposure. Apart from recommending change in strategies and improvement in operations, the factor includes requiring additional capitalization and granting additional loans.

The second dominating response strategy in both the samples is largely one of legal recovery measures explaining 17.6 percent and 14.9 percent of the variance in the US and Canadian samples respectively. These two factors spanning workout and legal recovery strategies together explain about 37 and 42 percent of the variance respectively for Canada and the US.

The remaining five strategies in each of the samples explain smaller percentages of the variance and a few do not have strong Alpha's. They include both workout and withdrawal strategies. While managerial changes combined with the first workout factor in the Canadian sample, it emerged as a separate factor in the US sample (7.6% of the variance). Some of the smaller factors, while explaining only a small part of the variance, had strong loadings and represented distinct strategies. Workout with long-term commitments got split into two factors in the US sample although the variables could conceptually combine as one factor. In the Canadian sample, the strategy named `exit with loss' (with strong loadings and explaining 8.5% of the variance) need not be only related to exit but could also represent a long-term commitment. Thus, some of the smaller factors are not conceptually very clear to interpret.

Three of the response variables, namely part forgiveness of the loan, sale of the loan, and exchanging debt for equity did not appear to be serious options (based on their means). They were excluded and the factor analysis performed again. However, the explanatory power of the factors did not improve substantially and the overall percentage of variance explained by the six new factors which emerged was slightly lower than that of the original factors. They are, therefore, not considered.

The various elements influencing these responses will now be discussed in the next section before relating the response strategies to the causes for the decline.

4. Elements Influencing the Response

The loan officer while representing the bank's interests begins to face possible conflicts in formulating a response strategy. While the primary objective would be to protect the banks funds at risk, the loan officer would also like to help the client turnaround, want to retain the client given competitive market conditions, bear in mind lender liability concerns, etc.

In order to understand more clearly the different considerations influencing the response of the bank, the loan officers were asked to identify 14 variables on a 5-point scale ranging from 1 (very important) to 5 (unimportant). Table 6.9 lists the variables and their mean and standard deviation for the US and Canadian samples.

Strongly identifying with the institutional objectives, `protection of the bank's funds at risk' is the most important variable in both US and Canada. Coming very close in importance are the variables `collateral value to the loan amount' and the `judgement on the client's ability to turnaround and repay'. The bank's judgement of management's turnaround ability was frequently stressed as very important during the interviews (also discussed in Chapter V) and finds support here. The `borrowers positive attitude towards the debt' and `which method will net the bank the greatest return on funds extended' are considered to be between `important' and `somewhat important'.

Significant differences between the US and Canadian samples exist in three variables. The US officers feel that the collateral value to loan amount and the need to protect the bank's funds at risk are more important than the Canadian officers do, and they are also more concerned about lender liability issues. The greater concern for lender liability among the US officers could explain their reluctance for the managerial interventions as part of the workout which assume greater importance among the Canadian responses. The importance of `collateral value to loan amount' influencing the response and the financial orientation of the primary response strategy falls into a pattern of greater importance for financial considerations among the US officers as compared to the Canadian officers. This focus gets magnified when considered along with the fact that, among the sample firms, a higher percentage of the US loans are fully secured (73.5%) as against the loans made by the Canadian banks (49.3%).

`Public image' and the `effect of the bank's action on the community' are considered to be of little importance. It is surprising that the `cost of collection of the loan' and the `cost and effort in rehabilitation of the borrower' are also considered to be of little importance. This supports the impression gained from the interviews that these banks did not view the handling of a problem loan on purely economic or cost/benefit terms. Neither is the 'value of the client to the bank as a customer' considered as very important.

The picture that emerges is that while the loan is considered as a business proposition and effort is made to protect the bank's funds, the bank's response strategy is an amalgam of economic and non-economic variables, and objective and subjective influences. It is certainly not a pure economic decision which determines the choice between liquidation and turnaround.

5. Discussion

The qualitative and quantitative data analyzed in this section help in developing an understanding of the complex nature of the response strategy of the loan officers.

Even though the nature of responses and elements influencing the responses are discussed as separate from recognition, the two take place simultaneously and are clearly connected. The rating system of the bank is a structural approach to recognition of and response to a problem loan. The bank's primary interest is in workout as against liquidation and this approach dominates its response strategies.

The banks rely on the loan officer to initiate recognition and response which is subject to supervision. However, during the interim period between problem recognition and transfer of the workout of the loan to another function within the bank, the loan officer has the field open for his efforts at turnaround.

The picture that emerges is one of two levels of response: an initial loan officer's response and a subsequent institutional response of the bank. Initially, once the problem recognition is initiated, the loan officer has the time (till the risk rating system determines a different set of responses), the inclination (since he wants to preserve a relationship and visualizes his role as an active one in helping the client), and the circumstances (early stages of the problem) to initiate a workout. As the problem worsens, the loan gets transferred to other decision making levels where further response strategies are pursued.

The picture is largely the same for both the US and the Canadian banks with a few variations. The Canadian loan officers have a managerial approach as their preferred response and have less of a concern for lender liability issues. The US officers have a preference for a financial response, which includes seeking additional coverage and guarantees. While the US officers are also inclined to giving extension of time for repayment and granting additional loans as part of their financial approach, they are more inclined to resort to the legal process for recovery.

In the next section, the causes for the problem as perceived by the loan officers will be discussed and related to their response strategies.

B. An Explanatory Model of Response Strategies

In order to understand the determinants of the banks' response strategies, apart from the elements influencing the responses examined earlier, it is important to understand the causes for the problem. The literature review in Chapter II examined the work of scholars who linked the turnaround strategies followed directly to the causes of failure. Thus, it is important to understand the causes of decline in these firms to help explain the response strategy followed. This section goes into the causes for the decline as perceived by the loan officers and then a regression model is presented to explain the response strategies.

1. Causes for Decline

The loan officers were asked to identify the causes, in their opinion, for the decline in financial performance of the client. A list of 19 variables were provided describing internal and external factors contributing to decline. The officers responded on a 5-point scale ranging from 1 (very important) to 5 (unimportant). The mean and standard deviation of the variables for the US and Canada are given in Table 6.10.

The most important cause for the decline in both the samples is `incompetent management'. This bears out the frequent comments of the bank officials interviewed and is consistent with their preoccupation with judging management ability as part of their response strategies. The literature on decline as also the Dun & Bradstreet statistics place a large share of the responsibility for decline on bad management.

The other causes considered important are: `heavy debt', `decreased profit margins of the products', `inadequate sales', `high overheads', `high operating expenses', `receivables difficulties', `weak top team', and `one-man rule'. Those considered to be relatively unimportant include: `poor location', `fraud', and `disasters'. `Neglect' due to reasons such as family/marital problems, health, etc. is also low among the list. Coming from the perspective of the bank official, it is perhaps not surprising that `high interest rates' is also rated low among the causes. The US and Canadian samples differed significantly ($p < .05$) in two variables, `receivables difficulties' and `disasters'.

A factor analysis of these causes was performed but the emerging factors did not reveal conceptually clear groupings. Instead, classifying the variables which are considered relatively more important into two groups presents an interesting picture. Grouping four variables as external causes (increased competition in the industry, high interest rates, declining market size, and receivables difficulties) and ten variables as internal causes (rapid growth/over expansion, heavy debt, decreased profit margins of the products, inadequate sales, high overheads, heavy operating expenses, incompetent management, unbalanced experience of the top team, one-man rule, and competitively weak), the internal causes appear to be more important. The mean for the internal causes for the US and Canada are 2.5 and 2.6 respectively while the mean for the external causes are 3.3 and 3.5 respectively (significant at $p < .05$). This is consistent with the results of another question wherein the officers were asked to allot 100 percent to three categories of reasons as contributing to the problem loan: firm, bank, and the environment. In the US sample, the means for the three sources are 67.5 percent for firm, 11 percent for the bank, and 21.5 percent for the environment. The pattern is similar for Canada where the corresponding figures are 69.9 percent, 8.8 percent, and 21.3 percent respectively. Thus, in both the samples, internal (firm related) causes are considered to be largely responsible for the problem as compared to external (bank and environmental reasons taken together).

2. Causes and Responses Strategies

The literature on turnaround strategies reviewed in Chapter II discusses the position of scholars who linked turnaround strategies with the causes for decline. The primary interest in workout on the part of the banks would also mean that their response strategy would have a relationship with their view of the causes for decline. To study the relationship between causes of the problem as perceived by the loan officers and their contemplated responses, Pearson correlation coefficients were calculated for the US and Canada. The correlations between the response factors (weighted using the factor loadings) and their component variables, with the causes are listed in Tables 6.11 and 6.12 for the US and Canada respectively. Tables 6.11a and 6.12a show the same information with only the significant correlations (at .05 and .01 levels) highlighted.

`High overheads' and `high operating expenses' being strong internal causes, are closely associated with the financial workout in the US and managerial workout in the Canadian sample. In the US, `high interest rates' and `competitively weak' as causes are associated with long-term workout, workout-structural, and recommending strategic change but not with management change or operating improvements. Thus, if external causes of decline are predominant, the officers don't consider changing management or improving operations as appropriate responses. In Canada, `high interest rates' and `competitively weak' are associated with structural changes like `mergers' and `downsizing the business', or `recall of the loan'.

In the US, incompetent management is strongly associated with recommending strategic changes and exit strategy such as recall of the loan. A weak top-team is associated with management change. In Canada, incompetent management and weak top-team are associated with management change and recall of loan. As noted earlier, consultants are resorted to more often than in the US.

The picture that emerges from the above correlations is that external causes of decline are responded to with more long-term and structural strategies. Operating and strategic reasons for decline are responded to with recommendation on operations/systems improvements. The association of management changes and exit strategies with the same set of causes can mean that if management change is not possible in those situations, the alternative is to exit through legal means if necessary.

3. A Regression Model

As an outcome of the discussion of the earlier sections, a regression model is presented in order to capture the joint effect of the causes and the other influences on the responses:

Response Strategy = f(Internal causes, external causes, security, severity, turnaround ability, cooperation)

a. The Variables. The independent and dependent variables in the model are made operational as below:

i) The internal cause for decline is represented by the variable `incompetent management.'

ii) The external cause for decline is represented by the variable `increased competition in the industry'. The above two are considered relatively important among the causes and are strongly correlated with the other internal and external reasons for decline, as the case may be.

iii) The extent of security or collateral available is represented by the response to `collateral value to loan amount' as an influential variable.

iv) The severity of decline is represented by the response to the question, "which of the following statements would best describe the firm when it was classified as a problem loan". The responses distinguished between temporary problems, serious causing a decline but not critical, and crisis which threatened the survival of the firm.

v) The turnaround ability is represented by the variable: `judgement on the client's ability to turnaround and repay'.

vi) The cooperation with the bank is represented by the variable `borrower's positive attitude towards the debt'.

vii) The dependent variable `response strategy' is represented by the response factors described earlier.

b. Results. The results of the regression analysis are listed in Table 6.13 giving the standardized coefficients along with the R squared and the F values for the US and Canadian samples. Table 6.13a provides a summary view with the significant coefficients highlighted. Except for severity, all the variables are on an interval scale ranging from 1 for `very important' to 5 for `unimportant' (or` will not be considered'). The severity is on a 3-point scale with 1 representing minor problems and 3 representing a crisis.

Going by the R squared, the model proved a better fit with the US data (mean R squared =.38) as compared to the Canadian data (mean R squared =.14) though individual variables are significant in more instances in the Canadian regressions that in the US. While individual elements are important, they operate in different combinations in the two samples.

In the US sample the primary financial workout strategy is influenced by cooperation. The exit strategy is influenced by more variables, though cooperation and internal causes alone are significant. Management change as a strategy is very strongly influenced by cooperation of the client.

In the Canadian sample, the primary managerial workout strategy is influenced by the causes of decline, importance of collateral value and the extent of cooperation. A legal recovery strategy is also influenced by the extent of severity of the problems. Surprisingly, the influence of turnaround ability does not appear to be strong on any of the strategies.

The limitations which must be kept in mind while interpreting this model is that the response factors (dependent variables), as described earlier, are not very precise and are only broad indicators of response objectives. The independent variables were selected on the basis of their importance, as an outcome of the preceeding quantitative and qualitative analysis, in influencing the response strategies. The data representing the variables were not defined, at the time of collection, to serve as inputs in this model. For example, the variable `judgment on management's turnaround ability' only measures the influence of that variable in formulating response and not the banker's judgment of management's turnaround ability. This is also true of the variables representing cooperation, and collateral value. Therefore, the coefficients of the independent variables do not reflect the direction of causation. Standardized coefficients are reported to facilitate the comparison of the relative importance of the variables.

4. Discussion

This section considered the relationship of the bank's response strategies with the causes of decline and other influences on the bank. Looking at the same issues from the perspective of the client raises concerns for strategic management.

The interventions which a bank plans in response to a situation of decline in a client is an external influence on the client's strategy. The literature on decline and turnaround strategies reviewed earlier looked at the turnaround strategies of a firm in relation to the causes of decline and connected the two. The assumption is that the turnaround strategy is directly determined by, and related to, the causes for the decline. The literature does not take into account the external influences on the strategy. The array of options available to a bank in order to intervene in a problem loan reveals the extent of the bank's influence on the firm's strategy. Scholars have suggested that operational causes for decline should be tackled with operating strategies, and strategic reasons for decline with strategic turnarounds. It is necessary that our understanding of turnaround strategies be re-calibrated to take into account these external influences, the sources of these influences, and the objectives behind them.

In the data studied, the bank's proposed workout strategy for the problem loan translates into a turnaround strategy for the firm. However, it is important to recognize that the strategy is initiated with the primary purpose of protecting the banks funds. The bank's measures of intervention in the firm to achieve a turnaround (in order to protect the bank's interests) need not correspond with the long-run interests of the firm. The data available in this study does not permit a discussion on whether or not there is a congruence. But it is reasonable to speculate that there is a greater possibility of congruence in the early stages of decline when the bank's funds are more likely to be fully protected. This leads to the possibility of differing response strategies due to the changing nature of objectives, in a dynamic context.

In the process of recognition and response, the bank appears to follow a system akin to the strategic analysis of the firm. Management ability is judged, the firm's performance in relation to the industry considered, external and internal reasons for the decline scrutinized, and the clients ability to generate a positive income flow in the future assessed. Once the firm has entered the problem loan category, the bank is constantly evaluating the firm's capacity for survival at various stages in its decline. The decision to be made is broadly workout or liquidation as a strategy. From a strategic management perspective, this analysis of the strengths and weakness in relation to the opportunities and threats in the environment is recommended as an on-going activity for the firm. During a time of decline, the analysis is being performed by an external agency also leading to a decision that affects the survival of the firm.

The bank's response, as argued in this chapter, is dependent on its perception of the causes for decline, apart from considerations of the cooperation of the client, extent of security, judgement on the client's ability to turnaround, severity of the problem, etc. These are variables which a firm can influence through its conscious action. Thus an outcome of this analysis for a decision maker in the firm is to provide him a better understanding of the forces acting on an influential player like the bank.

C. Size and Other Issues

In this section, the question of firm size and its influence on the nature of management research concerns, the questions relating to lender liability, and the variance between bank's in their approach to problem recognition, are considered.

1. Size of the Firm

The impact of the size of the firm on issues concerning decline and turnaround is not often explicitly made in the literature. The population ecology perspective would suggest that as an organization increases in size, it becomes more bureaucratic and inefficient and less flexible to adapt to changing circumstances. Adams and Brock (1987) have argued that once firms become big, they are considered to be too important to be allowed to fail. Scott (1976) agrees that survival of large organizations is seldom threatened by internal shocks.

Empirical research in the field of decline and turnarounds suffers from a size bias. Due to the dependence on data bases such as PIMS, COMPUSTAT, etc. or published case studies, it is the large firms which get frequently analyzed. At the other end of the spectrum, studies in the field of entrepreneurship look into survival rates and causes of start-up failures of fledgling firms. Schwartz & Menon (1985) comparing failing firms with non-failing firms do not find size (defined by operating sales revenue) to make a difference in the frequency of executive succession.

In a study undertaken for the Commission on Bankruptcy Laws (1973), Fredland reported that except for very large firms, there is very little statistical relationship between size, as measured by sales, employees and fixed assets, and the likelihood of failure. The National Small Business Administration reported that small businesses (defined as those with liabilities of $100,000 or less) accounted for 50.5 percent of the 1981 failures. The Dun & Bradstreet figures showing that 95 percent of the failures involve liabilities of less than $1 million (Committee on Small Business, 1982) also stress the high failure rate among small businesses..

Thus, it appears that while the extent of failures is quite substantial among small businesses, most studies have looked at large ones, and research specifically including size as a variable has been sketchy. In the present study, the respondents were asked where possible to choose firms which had been in existence for five years or more. While there was no pre-condition on size, they were asked to categorize the firms as small, medium and large, from the bank's perspective. Table 6.14 shows that almost all the firms reported on are between small and medium. During interviews, the loan officers and senior bank officials discussed issues relating to large firms too. This makes it possible to develop an appreciation of the variance in recognition and response issues due to the size of the client.

In lending to large firms, it is usually probable that more than one bank is involved in a syndicate. While the largest lender takes the role of the lead bank and the others follow, during times of crisis in the firm, bankers remarked that it is a big problem for the banks to agree on a common response strategy amongst themselves. The many judgmental issues involved lead to disagreement in approach and banks often worry if one lender is able to extract a better priority in loan repayment or security as against the others. A frequently used strategy in such situations is for one or more dominant lender(s) to buy-out the smaller lenders.

The question of size is closely related to the issue of ownership and control. Table 4.2 shows that about 94 percent of the client firms in both samples are owner-managed. Where this is so, the bankers feel that a supreme CEO (also usually the entrepreneur) may often be blind to organizational faults and the firm may suffer from an imbalance in managerial skills. But once convinced, it is easy to get him or her to act. In professionally managed firms, the bankers perception is that the chance of self-recognition of problems and corrective action is greater. One senior lending officer reported that among 60 percent of his large-corporate clientele, there is still little separation between ownership and management. Though there may be a board of directors and public holding of equity, management is still dominated by the owners. However, much of scholarly research on decline and turnaround strategies has ignored the question of size or nature of management. There is an underlying assumption of large size and professional management, often dictated by the nature of the sample.

One important area where the question of size and ownership/control issue has a bearing is that of change of management. Management change has frequently been considered in the literature as a necessity and sometimes as a precondition for successful turnaround strategies in a firm (Chapter II). When there is no separation between ownership and control, change in management would be tantamount to sale of the firm. Moreover, banks are wary of exercising or appearing to exercise control over the firm on account of lender liability considerations (discussed subsequently). One banker even commented that "if we were suggesting a change in management, the client is more likely to change banks." Thus, when management change is not a feasible option, other types of intervention become necessary.

A common approach to the question of management capabilities requiring changes is through appointing a consultant. Not only does it serve to impress on the client that the bank is concerned enough to want an independent opinion, it serves as a buffer against charges of lender liability. Banks maintain a list of consultants who specialize in workout situations and allow the firm to choose any one for the purpose. One senior vice president in charge of workout read out to the researcher sections of a consulting firm's report on a large troubled client where the consultant was evaluating the capabilities of individual members of the top management team. The banker remarked that they would push for a management change in that particular case as part of their workout package. Loan officers reported that at their level, they would sometimes resort to a direct confrontation with the client (possibly using a confidant of the client like an attorney or accountant) to discuss managerial weakness. Most often, the approach is to make oblique suggestions and recommendations to the client on the need to strengthen top management, point out weak areas of expertise, and use shocks such as asking the client to find another bank if there is a lack of agreement between the client and the bank. "It takes a shock like refusing a line of credit or calling them in to discuss concerns of the account to serve as a catalyst for change of management structure," explained one loan officer.

The response option of exchanging debt for equity in the firm as part of a workout strategy is another one that favors large firms, particularly when there is public trading of stock. This is, however, not a universally popular move and varies between banks. A few of the bankers stated that they use it as a specific policy tool in some cases with the objective of providing relief to the client in the short run but benefiting from the sacrifice and risk taken through more than proportional returns in the long run. But there were others who stated that it was definitely against their bank policy to exchange debt for equity.

While banks frequently denied any difference in the way they treat large and small problem loans, odd comments such as "the time and effort must be justified.." indicate that differences in treatment due to size cannot be ruled out. The responses show that banks do not apparently make cost/benefit calculations. Discussions with the bankers indicate that if the problem does not get resolved at the level of the loan officer, an institutional response is influenced by questions of size and extent of financial involvement.

To sum up, the effect of the size of the firm on decline and turnaround issues is considerable. However, neither has past empirical research specifically included size as a variable, nor qualified its conclusions.

2. Lender Liability

The question of lender liability has been mentioned in earlier sections as affecting responses at the level of the loan officer and in the nature of the bank's policy towards problem loans. In the broad sense in which it is used, the term `lender liability' deals with the liability on the part of lenders in the downfall of the business; at some point bankers can exert so much influence on a company that they become liable for its failure. The issue gained in importance some time ago when in 1976, in the case of the Farah Manufacturing Company, the firm was in trouble and the bankers replaced the CEO, William Farah. The troubles got worse and Farah managed to regain control in 1978 and revived the firm, and sued the banks claiming their involvement damaged it. A Texas court in 1982 awarded the firm $18.9 million in damages. More cases have come to light but there is a feeling among the bankers that while cases often go against them in the trial courts, their chances are better in the appeals court.

Some bankers feel the Farah case and subsequent ones have altered the way business is done. "What was considered normal banking practice, even giving of advice is held back to avoid giving impression of control," said one vice-president in charge of workout. Clauses about `no changes in management' or `replace with comparable management' included in covenants are toned down. The lawyers are involved early in a workout process to protect the bank's interests from a legal angle, suggestions are carefully worded, and consultants are used.

In the discussion earlier about elements influencing the response of the bank, the significant difference between the US and Canada in the importance of lender liability concerns was pointed out. The absence of jury trials or punitive damages, in addition to laws favoring creditors more generally have made it less of a concern in Canada. However, bankers have seen a few lender liability cases in Canadian courts too and feel that it is the influence of decisions in the US courts that is affecting the judiciary's approach.

A few of the bankers who do not express grave concerns about the lender liability issue feel that it is just reward for inappropriate behavior on the part of the bank. A few of the US bankers also quoted instances where errant borrowers use the lender liability issue as a negotiating tool with the bank in return for release from personal guarantees.

To sum up, there are genuine concerns about not wanting to exercise control especially among the US banks, and it appears to have altered the way they influence the firm in a problem loan situation. While the approach was more direct erstwhile, it is more indirect now. Banks are wary of giving direct advice and it is a major development in a bank-client relationship. It is possible that in marginal cases where previously a workout strategy might have been preferred, there would be a greater inclination for an exit strategy now. By and large, bankers are in the process of accepting it as part of the current lending environment necessitating suitable changes in their policies and procedures.

3. Variance Between Banks

The number of respondents from individual banks is not sufficient to able to test for differences between them in their responses. However, on the basis of the discussions, it is possible to identify areas where differences in basic approach or philosophy of the bank to problem loans differentiates between their recognition and response patterns.

While all banks are uniformly interested in early recognition and would prefer a workout of the problem, distinctions can be made in the implementation of their policies. Among the Canadian banks, one relied on an automated system of controls for the corporate office to monitor all problem loans. This bank incorporated within its rating system an option of withdrawing from the loan by sale to another bank at an early stage of decline as a specific response strategy. (However, a loan officer interviewed admitted the problems in implementing that approach due to the difficulty of the borrower finding a willing bank.) This reveals a conservative attitude of the bank in preferring to withdraw from the loan if possible at an early stage. This same bank does not have a centralized workout department but leaves it to the loan officer to administer the workout. There is close supervision from district and corporate offices, and decision making on the response strategies shifts to higher levels beyond a risk category, while still administered through the loan officer. One of the US banks, which had recently seen a change of the CEO subsequent to a merger with another bank described how the new CEO's preference was to be more accommodating in an effort to workout rather than to confront the client for a quick settlement. While two of the Canadian banks reported their willingness to consider accepting stock in the firm as part of a restructuring strategy, a third definitely ruled it out as against company policy.

A bank's attitude towards its problem loan client is also revealed in the officers' description of the client's status after a successful workout. Some banks were very sure that most of their clients preferred to leave because of a (real or imagined) stigma of having gone through a workout due to loss of credibility, etc. Some others were equally definite that most of their successful workouts preferred to stay though in some cases handled by a different loan officer. It is possible that these differing conclusions are a result of the differences in the way the clients are dealt with.

There are differences in the way banks structure their handling of the loans. This has been covered earlier. In the US, as the banks grow in size they tend to separate workout as a function from loan review. One bank felt they had a larger workout department than comparable banks because of their philosophy of trying to help the clients workout rather than to find an early exit. (This bank also believed that it was able to retain a large number of its clients after workout.)

The implications of these variations can be important for a manager. A particular bank's philosophy, attitude to problem loans, and handling of them needs to be understood by the client in order to obtain suitable assistance as part of a turnaround strategy.

The next chapter will provide a summary and a discussion of the overall implications of this study for research and for managers.

Table 6.1

Responsibility for Handling the Problem Loan

ITEM	US %	Canada %
1. Loan Officer exclusively handling the problem loan	50	71
2. Handling with assistance from loan review/workout department	41.2	16.6
3. Loan transferred to work-out department though loan officer still involved	2.9	4.1
4. Loan transferred to work-out department and loan officer not involved	5.9	8.3

Table 6.2

Role of the Loan Officer

Item	Very Important %	Somewhat Important %	Unimportant %
Provide an early warning to a firm of an impending crisis			
US	90.5	9.5	0
CANADA	82.1	17.9	0
Help a client to the extent possible in overcoming problems			
US	82.6	17.4	0
CANADA	78.8	19.0	1.2

Table 6.3

Lags in Classification

(Mean number of weeks; standard deviation in parantheses)

Item	US	Canada
Time lag between identification of a problem and its classification as a "problem loan"	11.96 (13.4)	11.30 (11.9)
Time lag between identification of a problem and the client being informed of the bank's concern	4.07 (5.24)	2.98 (6.1)

Note: Where response was given $\leq$ 7 days or as "immediate" etc was coded as 1 week

Table 6.4

Means of Response Variables

ITEM	US		Canada		t
	Mean	s.d.	Mean	s.d.	
1.Seeking additional collateral for existing loans	2.38	1.56	2.83	1.59	
2. Seeking guarantees in addition to existing collateral	2.84	1.53	2.82	1.58	
3. Granting additional loans with collateral/guarantees	3.90	1.27	3.83	1.45	
4.Time extension of the due date of the debt	2.47	1.33	3.32	1.48	**
5. Partial forgiveness of the debt	4.37	1.1	4.56	0.99	
6. Sale of loan to another bank	4.60	0.81	4.04	1.30	*
7. Terminate the loan allowing client time to find another bank	3.16	1.42	3.03	1.40	
8. Recommend additional capitalization	2.47	1.30	2.31	1.44	
9. Recommend downsizing business/asset divestment	2.89	1.61	3.03	1.59	
10. Recommend merger/acquisition by another	2.63	1.47	3.15	1.65	
11. Recommend change of top management (CEO)	3.23	1.67	3.60	1.52	
12. Recommend change of key personnel	3.58	1.34	3.41	1.50	
13. Recommend change of strategies	2.87	1.50	2.92	1.38	
14. Recommend use of consultants	3.00	1.57	3.06	1.59	
15. Suggest impeovement in systems & controls	3.10	1.47	2.86	1.54	
16. Suggest improvements in operations/cost reductions	2.45	1.55	2.67	1.42	
17. Recall of loan	2.33	1.32	2.67	1.45	
18. Proceed to recover through state courts	2.97	1.43	3.80	1.37	**
19. Proceed to recover through bankruptcy courts	3.33	1.49	3.94	1.34	*
20. Settle out of court with loss of interest	4.10	1.06	4.26	1.11	
21. Settle out of court with loss of interest & principal	3.97	1.30	4.26	1.16	
22. Exchange of debt for an equity position	4.30	1.18	4.67	0.87	

* $p \leq .05$ ** $p \leq .01$

Table 6.5

Correlation of Response Variables - US

ITEM	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20	21	22
1.Addtl collateral	1.0																					
2.Guarantees	52**	1.0																				
3.Addtl loans	50**	46*	1.0																			
4.Time extn	30	37*	-04	1.0																		
5.Part forgiveness	-14	04	-04	11	1.0																	
6.Sale of loan	-01	25	11	05	29	1.0																
7.Term with time	08	-04	-03	00	11	21	1.0															
8.Addtl capital	34	59**	38*	23	-16	18	33	1.0														
9.Rec. downsize	23	32	12	24	22	25	32	47**	1.0													
10.Rec. merger	06	08	-05	23	28	25	42*	27	50**	1.0												
11.Rec top change	-04	05	09	26	26	-11	-04	28	30	16	1.0											
12.Rec mgr change	07	42*	19	32	00	14	-11	41*	01	-09	47**	1.0										
13.Rec strg change	41*	71**	24	38*	11	15	-05	59**	23	18	20	49**	1.0									
14.Rec conslt	42*	26	-17	52**	01	24	01	33	32	24	-04	19	37*	1.0								
15.Syst impr	49**	23	14	32	29	26	31	21	32	06	11	00	19	58**	1.0							
16.Opers impr	33	49**	42*	38*	19	33	-02	57**	39*	26	26	39*	80**	39*	24	1.0						
17.Loan recall	-13	-10	-33	-08	19	10	53**	-07	19	13	-17	-29	-19	01	11	-19	1.0					
18.State courts	13	21	00	-06	40*	41*	12	-12	09	26	-29	-25	10	09	20	10	24	1.0				
19.Btcy court	-19	-06	-21	14	22	34	05	-19	13	32	-10	-21	-09	09	02	09	09	64**	1.0			
20.Setl int loss	-13	13	-19	-01	20	37*	03	-05	-07	05	-24	03	18	06	03	07	-24	58**	59**	1.0		
21.Setl int/pcl loss	-31	05	-17	17	44*	51**	36*	22	36*	43*	-25	09	10	04	06	25	30	25	51**	43*	1.0	
22.Ex debt equity	-23	09	-16	11	66**	06	-04	-03	24	14	20	09	22	08	11	27	16	20	20	29	48**	1.0

* $p \leq .05$,two tailed test

** $p \leq .01$

Continued, next page

Table 6.5a (cont.)

(Significance Highlighted)

ITEM	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20	21	22
1.Addtl collateral	1.0																					
2.Guarantees	**	1.0																				
3.Addtl loans	**	*	1.0																			
4.Time extn	.	*	.	1.0																		
5.Part forgiveness	.	.	.	.	1.0																	
6.Sale of loan	.	.	.	.	.	1.0																
7.Term with time	.	.	.	.	.	.	1.0															
8.Addtl capital	.	**	*	.	.	.	.	1.0														
9.Rec. downsize	.	.	.	.	.	.	.	**	1.0													
10.Rec. merger	.	.	.	.	.	.	*	.	**	1.0												
11.Rec top change	.	.	.	.	.	.	.	.	.	.	1.0											
12.Rec mgr change	.	*	.	.	.	.	.	*	.	.	**	1.0										
13.Rec strg change	*	**	.	*	.	.	.	**	.	.	.	**	1.0									
14.Rec conslt	*	.	.	**	.	.	.	.	.	.	.	.	*	1.0								
15.Syst impr	**	.	.	.	.	.	.	.	.	.	.	.	.	**	1.0							
16.Opers impr	.	**	*	*	.	.	.	**	*	.	.	*	**	*	.	1.0						
17.Loan recall	.	.	.	.	.	.	**	.	.	.	.	.	.	.	.	.	1.0					
18.State courts	.	.	.	.	*	*	.	.	.	.	.	.	.	.	.	.	.	1.0				
19.Btcy court	.	.	.	.	.	.	.	.	.	.	.	.	.	.	.	.	.	**	1.0			
20.Setl int loss	.	.	.	.	.	*	.	.	.	.	.		.	.	.	.	.	**	**	1.0		
21.Setl int/pcl loss	.	.	.	.	*	**	*	.	*	*	.	.	.	.	.	.	.	.	**	*	1.0	
22.Ex debt equity	.	.	.	.	**	.	.	.	.	.	.	.	.	.	.	.	.	.	.	.	**	1.0

* $p \leq .05$, ** $p \leq .01$, two tailed test

Table 6.6

Correlation of Response Variables - Canada

ITEM	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20	21	22
1.Addtl collateral	1.0																					
2.Guarantees	59**	1.0																				
3.Addtl loans	24**	28**	1.0																			
4.Time extn	29**	15	32**	1.0																		
5.Part forgiveness	-03	02	03	14	1.0																	
6.Sale of loan	09	07	-03	09	05	1.0																
7.Term with time	16	16	-11	03	-14	43**	1.0															
8.Addtl capital	26**	31**	18 *	12	-02	15	25**	1.0														
9.Rec. downsize	30**	32**	13	20**	-06	26**	34**	24**	1.0													
10.Rec. merger	25**	18 *	15	26**	19 *	16	08	32**	26**	1.0												
11.Rec top change	15	18 *	-04	12	19 *	12	14	26**	06	33	1.0											
12.Rec mgr change	16	14	12	08	09	05	18 *	36**	17	20 *	62**	1.0										
13.Rec strg change	28**	20 *	-03	12	00	06	11	31**	39**	05	43**	46**	1.0									
14.Rec conslt	30**	20 *	12	10	11	08	02	22 *	20 *	34**	50**	42	47**	1.0								
15.Syst impr	31**	26**	10	24**	-05	20 *	22 *	40**	45**	21 *	39**	48**	58**	43**	1.0							
16.Opers impr	32**	20 *	19 *	27**	01	08	05	43**	32**	20 *	30**	43**	56**	44**	73**	1.0						
17.Loan recall	10	03	-15	04	16	01	25**	-19 *	00	12	11	-04	-12	13	-03	-23**	1.0					
18.State courts	09	05	-10	-04	16	-05	19 *	-17	-08	06	13	02	-08	12	00	-14	55**	1.0				
19.Btcy court	19 *	17	03	09	15	-10	16	-06	-03	18 *	22	17	-16	15	01	-03	56**	60**	1.0			
20.Setl int loss	12	10	01	16	35**	-01	09	16	08	28**	14	12	06	12	14	08	33**	47**	41**	1.0		
21.Setl int/pcl loss	05	07	01	11	56**	-07	02	04	-06	29**	19 *	19 *	-01	21 *	09	00	36**	52**	45**	79**	1.0	
22.Ex debt equity	-09	00	00	13	36**	07	-01	-06	12	-03	-01	06	22 *	-07	04	08	-05	11	00	30**	30**	1.0

* $p \leq .05$,two tailed test

** $p \leq .01$

Continued, next page.

Table 6.6a (cont.)

(Significance Highlighted)

ITEM	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20	21	22
1.Addtl collateral	1.0																					
2.Guarantees	**	1.0																				
3.Addtl loans	**	**	1.0																			
4.Time extn	**	.	**	1.0																		
5.Part forgiveness	.	.	.	.	1.0																	
6.Sale of loan	.	.	.	.	.	1.0																
7.Term with time	.	.	.	.	.	**	1.0															
8.Addtl capital	**	**	*	.	.	.	**	1.0														
9.Rec. downsize	**	**	.	**	.	**	**	**	1.0													
10.Rec. merger	**	*	.	**	*	.	.	**	**	1.0												
11.Rec top change	.	*	.	.	*	.	.	**	.	.	1.0											
12.Rec mgr change	.	.	.	.	.	.	*	**	.	*	**	1.0										
13.Rec strg change	**	*	.	.	.	.	.	**	**	.	**	**	1.0									
14.Rec conslt	**	*	.	.	.	.	.	*	*	**	**	.	**	1.0								
15.Syst impr	**	**	.	**	.	*	*	**	**	*	**	**	**	**	1.0							
16.Opers impr	**	*	*	**	.	.	.	**	**	*	**	**	**	**	**	1.0						
17.Loan recall	.	.	.	.	.	.	**	*	.	.	.	.	.	.		**	1.0					
18.State courts	.	.	.	.	.	.	*	.	.	.	.	.	.	.	.	.	**	1.0				
19.Btcy court	*	.	.	.	.	.	.	.	.	*	.	.	.	.	.	.	**	**	1.0			
20.Setl int loss	.	.	.	.	**	.	.	.	.	**	.		.	.	.	.	**	**	**	1.0		
21.Setl int/pcl loss	.	.	.	.	**	.	.	.	.	**	*	*	.	*	.	.	**	**	**	**	1.0	
22.Ex debt equity	.	.	.	.	**	.	.	.	.	.	.	.	*	.	.	.	.	.	.	**	**	1.0

* $p \leq .05$, ** $p \leq .01$, two tailed test

Table 6.7

Response Factors - US

ITEM	Factor Loadings	Eigen Values	% of Variance	Alpha
1.Workout-finl		5.35	24.3	.86
Addtl collateral	.62			
Guarantees	.77			
Addtl loans	.84			
Addtl capital	.61			
Rec strg change	.71			
Opers impr	.73			
2.Exit-legal		3.88	17.6	.81
Sale of loan	.58			
State courts	.76			
Btcy court	.76			
Setl int loss	.91			
3.Workout - lt(I)		2.15	9.8	.76
Time extn	.59			
Rec conslt	.89			
Syst impr	.89			
4.Workout-lt(II)		2.07	9.4	.84
Part forgiveness	.87			
Ex debt equity	.86			
5.Mgt change		1.68	7.6	.72
Rec top change	.77			
Rec mgr change	.76			
6.Withdraw-loss		1.20	5.4	.67
Term with time	.85			
Loan recall	.67			
Setl int/pcl loss	.48			
7.Workout-structural		1.06	4.8	.66
Rec downsize	.64			
Rec merger	.83			
Total			79.0	.83

Table 6.8

Response Factors - Canada

ITEM	Factor Loadings	Eigen Values	% of Variance	Alpha
1. Workout-mgrl		4.84	22	.84
Rec top change	.72			
Rec mgr change	.74			
Rec strg change	.76			
Rec conslt	.68			
Syst improv	.74			
Opers improv	.72			
2. Recover-Legal		3.29	14.9	.78
Loan recall	.82			
State courts	.78			
Btcy courts	.77			
3. Exit with loss		1.88	8.5	79
Part forgiveness	.71			
Setl int loss	.79			
Setl int/pcl loss	.81			
Ex debt equity	.69			
4. Reduce exposure		1.54	7.0	.69
Addtl collateral	.66			
Guarantees	.74			
Addtl capital	.54			
Rec downsize	.43			
5. Withdraw		1.50	6.8	.54
Sale of loan	.77			
Term with time	.73			
6. Wo-fin involvement		1.17	5.3	.47
Addtl loans	.47			
Time extn	.71			
7. Rec merger				
(One variable only)	.62	1.03	4.7	- -
Total			69.3	.81

Table 6.9

Elements Influencing the Responses

ITEM	US		Canada		t
	Mean	s.d.	Mean	s.d.	
1. Public image	3.8	1.3	3.9	1.1	
2. Borrower's positive attitude towards the debt	2.4	1.4	2.6	1.3	
3. Borrower's negative attitude towards the debt	3.3	1.7	3.7	1.5	
4. Judgement on the client's ability to turnaround and repay	1.7	1	1.9	1	
5. Collateral value to loan amount	1.4	0.6	2	1.1	**
6. Value of the client to the bank as a customer	3.5	1.1	3.5	1.1	
7. Cost of collection of the loan	3.7	1.3	3.5	1.2	
8. Cost and effort in rehabilitation of the borrower	3.7	1.2	3.5	1.2	
9. Which method will net the bank the greatest return on funds extended	2.7	1.5	2.4	1.4	
10. Effect of the bank's action on the community	3.8	1.4	3.9	1.1	
11. Firm's performance in relation to the industry	3.5	1.4	3.2	1.3	
12. Lender liability issues	2.9	1.6	3.9	1.2	**
13. Protection of the bank's funds at risk	1.3	0.5	1.8	1.1	*
14. Attitude of the other creditors	3.6	1.2	3.5	1.3	

* $p \leq .05$
** $p \leq .01$

Table 6.10

Causes for the Decline

ITEM	US		Canada		
	Mean	s.d.	Mean	s.d.	t
1. Rapid growth/Over expansion	3.0	1.4	3.2	1.6	
2. Inadequate capacity	3.3	1.3	3.5	1.5	
3. Poor location	4.2	1.3	4.1	1.2	
4. Heavy debt	2.2	1.3	2.7	1.4	
5. Decreased profit margins of the products	2.6	1.3	2.5	1.4	
6. Increased competition in the industry	3.0	1.3	2.8	1.4	
7. High interest rates	3.7	0.9	3.9	1.1	
8. Declining market size of the industry	3.5	1.4	3.5	1.4	
9. Inadequate sales	2.7	1.4	2.4	1.5	
10. High overheads	2.3	1.3	2.4	1.4	
11. Heavy operating expenses	2.2	1.4	2.6	1.4	
12. Receivables difficulties	2.8	1.7	3.7	1.5	*
13. Incompetent management	1.8	1.1	2.0	1.1	
14. Unbalanced experience in the top team	2.3	1.6	2.3	1.3	
15. One-man rule	2.7	1.7	2.7	1.5	
16. Competitively weak	3.4	1.4	3.3	1.3	
17. Neglect(family problems, etc.)	3.5	1.5	4.0	1.4	
18. Fraud	4.2	1.2	4.4	1.3	
19. Disaster(fire etc.)	4.4	1.2	4.8	0.7	*

* $p \leq .05$

Table 6.11

Correlation of Causes and Responses - US

Item	Rapid Gro-wth	Low Capa-city	High Debt	Low Mar-gins	Inds Com-ptn	High Inte-rest	Dec mkt size	Low sales
1. Workout-finl	19	-01	11	33	-11	19	18	26
Addtl collateral	47**	-02	22	32	-17	-03	00	02
Guarantees	18	00	00	37*	02	21	15	36
Addtl loans	04	01	12	25	-30	-17	07	20
Addtl capital	24	13	-07	29	00	27	26	22
Rec strg change	10	10	09	24	10	33	12	16
Opers improv	-08	07	16	17	09	05	35	30
2. Exit-Legal	-06	44*	47*	32	46*	39*	12	08
Sale of loan	-01	00	13	20	09	29	28	06
State courts	-02	34	22	21	23	21	-08	-01
Btcy courts	-20	35	44*	25	45	36	25	12
Setl int loss	-02	45*	46*	22	45*	33	-03	06
3. Workout-lt(I)	26	-08	22	31	00	35	42*	06
Time Extn	-01	-13	09	04	08	35	43	06
Rec conslt	26	-18	18	19	06	33	33	01
Syst impr	30	11	25	46*	-12	19	30	09
4. Workout-lt(II)	01	13	27	-04	05	48**	28	-01
Part forgiveness	03	04	20	06	-15	38	27	-01
Ex debt equity	00	19	29	-12	23	49**	23	-01
5. Mgt change	-07	-04	02	19	-09	05	33	36
Rec top change	-10	00	07	13	-07	10	34	32
Rec mgr change	00	-06	-05	19	-09	-03	21	29
6. Withdraw-loss	19	-11	07	29	10	45*	04	-16
Term with time	09	-17	07	29	04	20	06	07
Loan recall	08	-14	-28	-01	05	14	-19	-29
Setl int/pcl loss	02	10	25	09	20	65**	18	-13
7. Workout-struct	07	-09	32	27	12	60**	61**	24
Rec downsize	04	-09	12	31	07	36	61**	35
Rec merger	07	-06	42*	17	13	66**	47*	09

* $p \leq .05$ ** $p \leq .01$ Continued, next page.

Table 6.11(cont.)

Item	High over heads	High oper exp	Rec. diffic	Inc-omp mgmt	Weak top team	One-man rule	Comp-tly weak	Neg-lect
1. Workout-finl	62**	59**	-02	-32	36	-09	21	-06
Addtl collateral	45*	36	09	00	27	01	01	06
Guanrantees	43*	42*	-02	-20	17	-14	21	-10
Addtl loans	43*	19	-05	-10	28	-11	03	02
Addtl capital	42*	54**	-09	-23	33	-14	16	-18
Rec strg change	51**	60**	01	-41	26	-14	24	-09
Opers improv	15	57**	65**	15	-42*	32	03	32
2. Exit-Legal	-04	20	26	09	-20	30	26	-03
Sale of loan	19	36	17	-01	14	-02	10	11
State courts	-05	11	06	18	-21	36	23	12
Btcy courts	-02	12	31	14	20	36	30	-15
Setl int loss	-16	11	24	-05	20	14	09	-05
3. Workout-lt(I)	25	34	07	-21	03	-13	15	-16
Time Extn	38*	42*	22	-35	00	-15	15	-11
Rec conslt	12	25	-03	-23	-05	-10	01	-25
Syst impr	19	22	16	10	12	-07	24	00
4. Workout-lt(II)	11	20	-09	-04	-12	18	47**	06
Part forgiveness	22	19	06	14	01	22	38*	23
Ex debt equity	-01	18	-21	-21	-23	19	48**	-11
5. Mgt change	61**	28	18	-07	50**	01	16	-02
Rec top change	52**	21	24	07	43*	14	26	-01
Rec mgr change	51**	27	06	-21	43*	-15	00	-02
6. Withdraw-loss	04	30	-03	31	09	20	40*	05
Term with time	04	14	04	29	14	23	25	-03
Loan recall	-16	02	-16	39*	-02	17	29	19
Setl int/pcl loss	16	36	19	04	12	20	39*	-02
7. Workout-struct	35	50**	13	00	18	43*	53**	-29
Rec downsize	37*	44*	15	07	25	38	62**	-27
Rec merger	24	44*	08	-06	08	38*	33	23

* $p \leq .05$ ** $p \leq .01$ Continued, next page.

Table 6.11a (cont.)

(Significance Highlighted)

Item	Rapid Growth	Low Capacity	High Debt	Low Margins	Inds Comptn	High Interest	Dec mkt size	Low sales
1. Workout-finl	.	.	.	.	.	.	.	.
Addtl collateral	**	.	.	.	.	.	.	.
Guanrantees	.	.	.	*	.	.	.	.
Addtl loans	.	.	.	.	.	.	.	.
Addtl capital	.	.	.	.	.	.	.	.
Rec strg change	.	.	.	.	.	.	.	.
Opers improv	.	.	.	.	.	.	.	.
2. Exit-Legal	.	*	*	.	*	*	.	.
Sale of loan	.	.	.	.	.	.	.	.
State courts	.	.	.	.	.	.	.	.
Btcy courts	.	.	*	.	.	.	.	.
Setl int loss	.	*	*	.	*	.	.	.
3. Workout-lt(I)	.	.	.	.	.	.	*	.
Time Extn	.	.	.	.	.	.	.	.
Rec conslt	.	.	.	.	.	.	.	.
Syst impr	.	.	.	*	.	.	.	.
4. Workout-lt(II)	.	.	.	.	.	**	.	.
Part forgiveness	.	.	.	.	.	.	.	.
Ex debt equity	.	.	.	.	.	**	.	.
5. Mgt change	.	.	.	.	.	.	.	.
Rec top change	.	.	.	.	.	.	.	.
Rec mgr change	.	.	.	.	.	.	.	.
6. Withdraw-loss	.	.	.	.	.	*	.	.
Term with time	.	.	.	.	.	.	.	.
Loan recall	.	.	.	.	.	.	.	.
Setl int/pcl loss	.	.	.	.	.	**	.	.
7. Workout-struct	.	.	.	.	.	**	**	.
Rec downsize	.	.	.	.	.	.	**	.
Rec merger	.	.	*	.	.	**	*	.

* $p \leq .05$ ** $p \leq .01$ Continued, next page

Table 6.11a(cont.)

Item	High over-heads	High oper exp	Rec. diffic	Inc-omp mgmt	Weak top team	One-man rule	Comp-tly weak	Neg-lect
1. Workout-finl	**	**	.	.	. .	.	.	.
Addtl collateral	*	.	.	.	.	.	.	.
Guanrantees	*	*	.	.	.	.	.	.
Addtl loans	*	.	.	.	.	.	.	.
Addtl capital	*	**	.	.	.	.	.	.
Rec strg change	**	**	.	.	.	.	.	.
Opers improv	.	**	**	.	*	.	.	.
2. Exit-Legal	.	.	.	.	.	.	.	.
Sale of loan	.	.	.	.	.	.	.	.
State courts	.	.	.	.	.	.	.	.
Btcy courts	.	.	.	.	.	.	.	.
Setl int loss	.	.	.	.	.	.	.	.
3. Workout-lt(I)	.	.	.	.	.	.	.	.
Time Extn	*	*	.	.	..	.	.	.
Rec conslt	.	.	.	.	.	.	.	.
Syst impr	.	.	.	.	.	.	.	.
4. Workout-lt(II)	.	.	.	.	.	.	**	.
Part forgiveness	.	.	.	.	.	.	*	.
Ex debt equity	.	.	.	.	.	.	**	.
5. Mgt change	**	.	.	.	**	.	.	.
Rec top change	**	.	.	.	*	.	.	.
Rec mgr change	**	.	.	.	*	.	.	.
6. Withdraw-loss	.	.	.	.	.	.	*	.
Term with time	.	.	.	.	.	.	.	.
Loan recall	.	.	.	*	.	.	.	.
Setl int/pcl loss	.	.	.	.	.	.	*	.
7. Workout-struct	.	**	.	.	.	*	**	.
Rec downsize	*	*	.	.	.	.	**	.
Rec merger	.	*	.	.	.	*	.	.

* $p \leq .05$ ** $p \leq .01$

Table 6.12

Correlation of Causes and Responses - Canada

Item	Rapid Gro-wth	Low Capa-city	High Debt	Low Mar-gins	Inds Com-ptn	High Inte-rest	Dec mkt size	Low sales
1 Workout-mgrl	27**	35**	24**	15	11	25**	05	-07
Rec top change	18*	26**	24**	07	-07	10	-10	-07
Rec mgr change	23**	19*	19*	07	05	14	-08	-05
Rec strg change	12	25**	10	20*	14	19*	10	-04
Rec conslt	28**	30**	34**	23*	07	28**	06	-15
Syst improv	33**	33**	16	16	05	12	10	-08
Opers improv	18*	20*	15	16	13	16	06	06
2. Recover-Legal	04	25**	11	08	05	-02	-03	-04
Loan recall	-05	25**	13	08	07	-01	03	00
State courts	09	24**	08	00	01	-01	-07	-08
Btcy courts	04	17	10	15	08	-02	-07	02
3. Exit with loss	14	02	23**	13	11	16	07	-01
Part forgiveness	12	05	32**	10	10	25**	11	06
Setl int loss	14	03	12	11	07	10	01	-04
Setl int/pcl loss	17	13	20*	15	10	09	06	00
Ex debt equity	-07	-09	04	06	15	09	07	07
4. Reduce exposure	27**	28**	04	15	17	23*	15	04
Addtl collateral	21*	24**	-02	25**	12	20*	16	06
Guarantees	15	17	07	03	16	16	06	12
Addtl capital	23*	18*	08	02	17*	17*	05	03
Rec downsize	22*	27**	16	18*	02	21*	27**	00
5. Withdraw	22	29**	12	10	-01	06	02	-15
Sale of loan	28**	23*	20*	14	-02	08	03	-20*
Term with time	11	30**	04	00	-01	01	00	-02
6. Wo-fin involve	23*	11	08	13	02	15	19*	07
Addtl loans	18*	11	06	-06	-07	11	18*	10
Time extn	20*	11	10	20*	06	15	13	06
7. Rec merger	11	20*	24**	34**	10	25**	14	13

* $p \leq .05$, ** $p \leq .01$ Continued, next page.

Table 6.12(cont.)

Item	High over heads	High oper exp	Rec. diffic	Inc-omp mgmt	Weak top team	One man rule	Comp-tly weak	Neg-lect
1. Workout-mgrl	43**	43**	10	30**	40**	21*	17	22*
Rec top change	32**	29**	16	39**	44**	32**	14	33**
Rec mgr change	33**	33**	07	30**	40**	23*	15	14
Rec strg change	19*	15	-04	14	19*	10	12	16
Rec conslt	27**	32**	19*	28**	32**	18*	10	17*
Syst improv	47**	41**	09	24**	32**	23*	06	15
Opers improv	46**	47**	-01	03	15	-03	08	06
2. Recover-Legal	04	08	36**	39**	21*	34**	24**	18*
Loan recall	-04	-01	35**	48**	28**	34**	25**	19*
State courts	-03	02	27**	27**	09	30**	13	15
Btcy courts	18*	16	36**	25**	15	23*	21*	15
3. Exit with loss	06	10	24**	11	10	25**	13	08
Part forgiveness	06	07	15	01	03	15	08	03
Setl int loss	11	11	27**	18*	16	20*	12	14
Setl int/pcl loss	10	15	32**	22*	22*	30**	22*	02
Ex debt equity	-03	02	01	-10	-11	07	-04	03
4. Reduce exposure	32**	21*	18	05	15	14	10	15
Addtl collateral	21*	15	19	09	13	10	16	10
Guarantees	26**	13	18	06	08	19	06	18*
Addtl capital	30**	19*	-02	-03	15	-03	05	01
Rec downsize	22*	18*	15	-01	11	09	-02	05
5. Withdraw	14	13	06	17	27**	08	03	03
Sale of loan	19*	19*	01	05	22*	-01	00	-05
Term with time	08	05	10	26**	26**	13	05	10
6. Wo-fin involve	18*	17*	07	-05	-01	12	02	12
Addtl loans	17	14	-02	-16	03	-01	-05	-07
Time extn	17	17	11	06	-02	15	05	19*
7. Rec merger	32**	38**	28**	15	24**	20*	22*	10

* $p \leq .05$ ** $p \leq .01$ Continued, next page

Table 6.12a (cont.)

(Significance Highlighted)

Item	Rapid Gro-wth	Low Capa-city	High Debt	Low Mar-gins	Inds Com-ptn	High Inte-rest	Dec mkt size	Low sales
1. Workout-mgrl	**	**	**	.	.	**	.	.
Rec top change	*	**	**	.	.	.	.	.
Rec mgr change	**	*	*	.	.	.	.	.
Rec strg change	.	**	.	*	.	*	.	.
Rec conslt	**	**	**	*	.	**	.	.
Syst improv	**	**	.	.	.	.	.	.
Opers improv	*	*	.	.	.	.	.	.
2. Recover-Legal	.	**	.	.	.	.	.	.
Loan recall	.	**	.	.	.	.	.	.
State courts	.	**	.	.	.	.	.	.
Btcy courts	.	.	.	.	.	.	.	.
3. Exit with loss	.	.	**	.	.	.	.	.
Part forgiveness	.	.	**	.	.	**	.	.
Setl int loss	.	.	.	.	.	.	.	.
Setl int/pcl loss	.	.	*	.	.	.	.	.
Ex debt equity	.	.	.	.	.	.	.	.
4. Reduce exposure	**	**	.	.	.	*	.	.
Addtl collateral	*	**	.	**	.	*	.	.
Guarantees	.	.	.	.	.	.	.	.
Addtl capital	*	*	.	.	*	*	.	.
Rec downsize	*	**	.	*	.	*	**	.
5. Withdraw	.	**	.	.	.	.	.	.
Sale of loan	**	*	*	.	.	.	.	*
Term with time	.	**	.	.	.	.	.	.
6. Wo-fin involve	*	.	.	.	.	.	*	.
Addtl loans	*	.	.	.	.	.	*	.
Time extn	*	.	.	*	.	.	.	.
7. Rec merger	.	*	**	**	.	**	.	.

* $p \leq .05$, ** $p \leq .01$ Continued, next page.

Table 6.12a(cont.)

Item	High over heads	High oper exp	Rec. diffic	Inc-omp mgmt	Weak top team	One-man rule	Comp-tly weak	Neg-lect
1. Workout-mgrl	**	**	.	**	**	*	.	*
Rec top change	**	**	.	**	**	**	.	**
Rec mgr change	**	**	.	**	**	*	.	.
Rec strg change	*	.	.	.	*	.	.	.
Rec conslt	**	**	*	**	**	*	.	*
Syst improv	**	**	.	**	**	*	.	.
Opers improv	**	**	.	.	.	.	.	.
2. Recover-Legal	.	.	**	**	*	**	**	*
Loan recall	.	.	**	**	**	**	**	*
State courts	.	.	**	**	.	**	.	.
Btcy courts	*	.	**	**	.	*	*	.
3. Exit with loss	.	.	**	.	.	**	.	.
Part forgiveness	.	.	.	.	.	.	.	.
Setl int loss	.	.	**	*	.	*	.	.
Setl int/pcl loss	.	.	**	*	*	**	*	.
Ex debt equity	.	.	.	.	.	.	.	.
4. Reduce exposure	**	*	.	.	.	.	.	.
Addtl collateral	*	.	.	.	.	.	.	.
Guarantees	**	.	.	.	.	.	.	*
Addtl capital	**	*	.	.	.	.	.	.
Rec downsize	*	*	.	.	.	.	.	.
5. Withdraw	.	.	.	.	**	.	.	.
Sale of loan	*	*	.	.	*	.	.	.
Term with time	.	.	.	**	**	.	.	.
6. Wo-fin involve	*	*	.	.	.	.	.	.
Addtl loans	.	.	.	.	.	.	.	.
Time extn	.	.	.	.	.	.	.	*
7. Rec merger	**	**	**	.	**	*	*	.

* $p \leq .05$ ** $p \leq .01$

Table 6.13

Multiple Regression of Response Factors
on Causes and Influences

Response Factors	Standardized Regression Coefficients							
	Internal Causes	External Causes	Collateral Value	Severity	Turnaround ability	Cooperation	R^2	F
US								
Workout-finl	-.13	-.17	.03	.09	.18	.45*	.36	1.79
Exit-legal	.36	.44*	.14	.25	-.20	.41*	.42	2.25*
Workout-lt(I)	-.01	-.02	.22	-.09	.38*	.35	.31	1.45
Workout-lt(II)	-.16	.00	.37	-.26	.09	.27	.23	.93
Mgt change	-.11	-.12	.12	-.11	-.07	.84****	.59	4.52***
Withdraw-loss	.02	-.04	.55**	.03	.49**	-.14	.45	2.60*
Workout-structural	.07	.17	.08	-.24	.55**	.00	.32	1.50
Canada								
Workout-mgrl	.39****	.18**	.20**	.05	.05	.23**	.25	5.76****
Recover-legal	.26***	.04	.16*	-.19**	.05	-.24**	.25	5.95****
Exit with loss	.07	.07	.13	-.17*	.06	.01	.07	1.43
Reduce exposure	.04	.15	.28***	.04	.09	.04	.13	2.68**
Withdraw	.18*	.10	.01	.15	.10	-.07	.06	1.18
Wo-fin involvement	-.01	-.02	.07	-.14	.08	.20**	.07	1.43
Rec merger	.17	.13	.19**	-.21*	-.07	.14	.15	3.08***

US sample n = 26, Canadian sample n = 113

Continued, next page.

* $p \leq .10$, ** $p \leq .05$, *** $p \leq .01$, **** $p \leq .001$

Table 6.13a (cont.)

(Significance Highlighted)

Response Factors	Standardized Regression Coefficients							
	Internal Causes	External Causes	Collateral Value	Severity	Turnaround ability	Cooperation	R^2	F
US								
Workout-finl	.	.	.	.	.	*	.36	.
Exit-legal	.	*	.	.	.	*	.42	*
Workout-lt(I)	.	.	.	.	*	.	.31	.
Workout-lt(II)	.	.	.	.	.	.	.23	.
Mgt change	.	.	.	.	.	****	.59	***
Withdraw-loss	.	.	**	.	**	.	.45	*
Workout-structural	.	.	.	.	**	.	.32	.
Canada								
Workout-mgrl	****	**	**	.	.	**	.25	****
Recover-legal	***	.	*	**	.	**	.25	****
Exit with loss	.	.	.	*	.	.	.07	.
Reduce exposure	.	.	***	.	.	.	.13	**
Withdraw	*	.	.	.	.	.	.06	.
Wo-fin involvement	.	.	.	.	.	**	.07	.
Rec merger	.	.	**	*	.	.	.15	***

US sample n = 26, Canadian sample n = 113

* $p \leq .10$, ** $p \leq .05$, *** $p \leq .01$, **** $p \leq .001$

Table 6.14

Size Distribution of Firms

Item	US %	Canada %
Small	64.7	57.5
Mid market	35.3	41.8
Large corporate	0.0	0.7
	—	—
Total	100	100

CHAPTER VII

SUMMARY, CONCLUSIONS, AND IMPLICATIONS

> "Severe adversity can undermine (the power of management) to some extent by leading other constituents to question the wisdom of managers and by increasing the firm's dependence on fresh resources that are controlled by others".
> - Philip Nelson (1981, p.69)

In this section, an overview of the study and its main conclusions are presented. The weakness in the study and the limitations it imposes on the conclusions are described, and implications drawn both for managers and for further research.

A. Summary

The role of commercial banks as an external agent triggering recognition of decline of a firm and their response strategies is explored in this study.

A review of the literature on business decline and turnaround shows that scholars have looked at: the causes for decline, prediction of failure, management of decline, types of turnaround strategies, and the need for management change as a precondition for or a part of turnaround. Management literature has also emphasized that an incumbent management is often guilty of delaying acknowledgement of the severity of its problems until it is quite late but ignores the question of recognition which is considered important by crisis theory. Examining the circumstances surrounding the decline of a firm, studies have suggested that it is possible to conceive of different levels of severity of the problem. While largely ignored by the management literature, a few scholars have suggested the possibility of sources external to the firm playing a part during this critical phase in the failure-turnaround sequence. It still needed to be examined whether the role included recognition of the problems facing the firm, and whether it could extend to influencing the firm's actions in its response to the problem.

With this background, the commercial bank was chosen as it is well situated to be an external source of recognition. Research has indicated that default on loans occurs earlier than filing for bankruptcy and cash flow crises are seen as early symptoms of a firm's difficulties. Thus, a commercial bank which is an external agency privy to confidential information and closely monitoring the performance of its client and to whom the client would approach for resolution of liquidity problems, can be an influential trigger for recognition.

The study was designed to explore how banks view problem loans, the process by which they recognize the problems, and the nature of their responses. An additional benefit of this approach is that it provided an opportunity for examining primary data and getting a glimpse of the process while a crisis is developing and actually taking place, rather than in retrospect. Given the differences in banking and regulatory structures, it is valuable to look at these questions in both US and Canadian banks as one sheds light on the other.

Through qualitative (interviews) and quantitative (questionnaire) means, data was collected on how banks distinguish between decline and failure, the cues that are used to identify a problem loan, and the array of responses a bank uses to intervene in the situation. An explanatory model using multiple regression is presented, to examine the joint effect of the various elements on the response strategies. Finally, the effects of the size of the firms, lender liability, and the variance between banks is discussed. The results of the study is not to show that the banks' view of the business failure is correct. Rather, it is to show how banks as external agents are a source of early recognition and their role extends to influencing the strategy of the firm.

B. Conclusions

The main conclusions of this study examined at different parts of the report are as presented below.

a) A business decline and failure situation is viewed by the bank as a problem loan. It is an important objective of the bank to recognize a problem loan early and respond to it by attempting to resolve the problem rather than take drastic measures such as liquidation. In the early stages of the problem in a firm, it is in the bank's interest to bring them to the attention of the client for early resolution. As the problems worsen and become more severe and the bank feels its assets being threatened, the same goal congruence need not exist since the bank is primarily concerned with protecting its own interests.

b) In identifying a problem loan, banks do make important distinctions in categorizing the severity of the problem. The key distinction is between a decline in the performance of the firm which is not life threatening and one which in fact is. In a stage of decline, the banks view the problems as minor when the ability of the firm to repay is not threatened; impending failure is a state which threatens that ability.

c) Through a risk rating system, banks attempt to structure and formalize their recognition and response mechanisms. Apart from providing guidelines, the systems attempt to make as objective as possible what is basically a very subjective decision. Response decisions are strongly influenced by very qualitative factors such as `trust' and `cooperation' of the client, judgement of the client's `ability' to turnaround, etc. The response of the bank not only depends on its understanding of the causes for decline (internal and external reasons) but is also influenced by the bank's judgement of the client's ability to turnaround, extent of security coverage available to the bank, its judgement of the severity of the problem, and its understanding of the cooperation of the client in working with the bank to resolve the problems. The size of the firm with its implication for the separation of ownership and management, also plays a role.

d) It is more meaningful to talk in terms of two levels of recognition and response by the bank; at the level of the loan officer and at the institutional level of the bank. The loan officer as the first line of defence, not only provides an early warning to the client but operating with slightly different objectives can be more accommodating. The loan officer attempts to preserve the bank's relationship with the client, for frequently as yet there is little threat to banks' funds, and the firm's problems are still at an early stage. When the handling of the loan is transferred to higher levels within the bank, problems are more severe, there is greater threat to the bank's funds and the bank has to be primarily concerned with its self-interest.

e) In comparing the process of recognition and response between US and Canada, while there were few differences between the two, the differences in the correlation structures show differences in approaches. While both the US and Canadian officers preferred a workout to an exit strategy, the US officers have a bias towards additional financial coverage while the Canadian officers prefer a managerial approach to workout. The latter show a greater willingness to use consultants as part of the turnaround effort and, perhaps due to less concerns about lender liability, would consider managerial changes as part of a primary workout strategy. Differences also emerged in classification and handling of the loan.

f) An attempt to represent the role of the commercial bank in a dynamic form is shown in Fig. 2 (p. 165). With the perspective of the firm, Fig. 1 (p. 36) visualizes the recognition process and the possible role of external agents. Narrowing it down to the bank as a representative case, Fig. 2 captures the results of the study focusing on the role of the bank as an external agent. The decline/failure of the firm will inexorably move it towards liquidation if left unattended. The bank plays a role through recognition and reponds with a workout strategy to aid the firm towards a revival. This is determined by the bank's objective, which can be characterized as enlightened self-interest. Depending on the combination of causes, severity of the problem, extent of security coverage, cooperation of the management, the bank's judgment of the management's ability to turnaround, and the size of the firm, the bank either works towards a revival or pushes for liquidation.

The levels of response are designated by the two overlapping triangles where the initial stages fall within the purview of the loan officer, gradually giving in to an institutional response of the bank concerned with protecting its interests. The dotted lines show the influence of one while within the purview of the other.

C. Limitations of the Study

As explained in Chapter IV discussing the research methodology, empirical studies into questions of decline and turnaround present additional difficulties when compared to normal empirical inquiry. Questions of failure and crisis are not as pleasant to discuss as those of growth and success. There are complications due to confidentiality and a lack of inclination on the part of the individual to discuss these issues even if the time were available.

This study also has its share of trade-offs. The nature and content of issues that were intended for study were seen as sensitive by the banks and it was not possible to expect participation on the basis of random selection. This prevents easy generalizations being made on the basis of this study and should be borne in mind.

The literature review suggested the possibility of the external recognition originating from among several stakeholders. While it is argued that the bank is a very influential participant in the process of recognition, it is only one among others which could include an investor group, venture capitalists, auditors, etc. In specific case situations, there are different combinations of these external agencies at work in the firm. Thus, the role of the commercial bank must be viewed in that perspective of being one among several possible triggers, albeit a very influential one.

By looking at the decline and failure of the firm though the eyes of the bank, the view tends to be one-sided. It was not possible to get references from the banks to talk to the clients for their perspective on the process of recognition and the bank's influence.

Banks are not perfect in their judgement or management. Banks are also susceptible to failure themselves. In addition, recent reports on the high percentage of non-performing loans in the portfolio of the Bank of New England and others can raise doubts on the efficacy of the recognition and response procedures of the banks.

In spite of these limitations this methodology of combining qualitative and quantitative techniques for exploring issues (the importance of which have been overlooked in the literature) through collection of primary data provides a better understanding of business decline and the turnaround process.

D. Implications for Research and Management

As noted above, the study makes a positive contribution to our understanding of the process of decline and the early stages of turnaround. Drawing on the need for early recognition of crisis from the crisis management literature, this study establishes the importance of problem awareness in the study of decline. Recognition of the severity of business decline is critical and affects the probability of success of a turnaround strategy since the earlier the recognition, the less the severity of the problem and the greater the chances of success.

Studies in the field of decline and turnaround have tended to view the role of management to the exclusion of external influences. It is assumed that management makes the recognition, earlier or later, and the existing or new management initiates a turnaround strategy. This study draws attention to the role of external influences in recognition of the problem and their effect on the turnaround strategy. The response of the bank to a problem loan, looked at from the perspective of the firm, is an external influence on the turnaround strategy. We have seen that there are various influences affecting this response. Management literature which directly links a turnaround strategy to the causes for decline errs to the extent that external influences, and motives behind that influence, are not taken into account.

Management literature has frequently stressed the role of bad management as one of the major causes of decline and efforts continue to try to pin down these factors collectively known as `bad management'. This study reveals a similar attempt on the part of a bank, while conducting the strategic analysis of the client, to judge management and appraise its ability to turnaround the firm. Research into questions of management change as part of a turnaround strategy would benefit from including consideration of the measures used by banks for the same purpose. With management change being a part of the array of responses of a bank, this study also hints at how the change could possibly be initiated, which is an issue not considered in the literature.

Empirical research in the field of decline and turnaround has suffered from a bias towards large firms on whom data is more easily available in the form of published case studies, data bases, etc. In smaller firms there is little separation between ownership and control, and management change is not always the only or most viable option. The array of responses used by a bank gives an indication that in addition to management change, other interventions are possible in the situation.

When a firm is in a stage of growth and prosperity, the stakeholders claim their share and leave management to manage. When times are bad and the firm is in a decline, strains begin to show. When failure seems possible, the stakeholders rush to protect their interests which often diverge from those of the management. This study highlights the real possibility of this divergence in the case of banks. There is a need for further research into the conflicting influences of different stakeholders serving their self-interests and impinging upon the turnaround strategy of the weakened firm.

The above discussion suggests that further research into questions of decline and turnaround needs to take into account external influences, alternate interventions, and the size of the firm as important factors. There is a need to temper this view of the banker with an inquiry into the view of the firm in the same situation. The ultimate effect on the firm (which is the victim in the situation) is as a result of the resolution or the conflict between the forces involved. Case studies looking at several external influences on the firm will enable researchers to identify situational factors enabling one set of external forces to be more dominant than another.

A direct implication of this study for managers is an understanding of the objectives of the banker (similar to those of the firm in the early stages) assists the manager in dealing with the bank and taking advantage of its assistance, while the matter is still in the purview of the loan officer. Openness with the banker in admitting the problems and seeking assistance can be beneficial to the firm. Management which recognizes and admits its problems and has developed a turnaround plan is in a better position to deal with the bank, and to seek their assistance.

A development of this argument is that a firm is better off initiating action on its own rather than waiting till an external recognition of its failure which brings with it external influences on the strategy of the firm and detracts the CEO from trying to meet the firm's objectives on his or her own. When such external influences do start impinging on a firm attempting a turnaround, an appreciation of the conflicts in the objectives of the external influences and those of the firm are a first step in attempting to reconcile them.

This study also highlights the importance of adequate training in workout for a loan officer. As the first line of defence in a situation where the earlier it is, the simpler it is, a loan officer can play a key role.

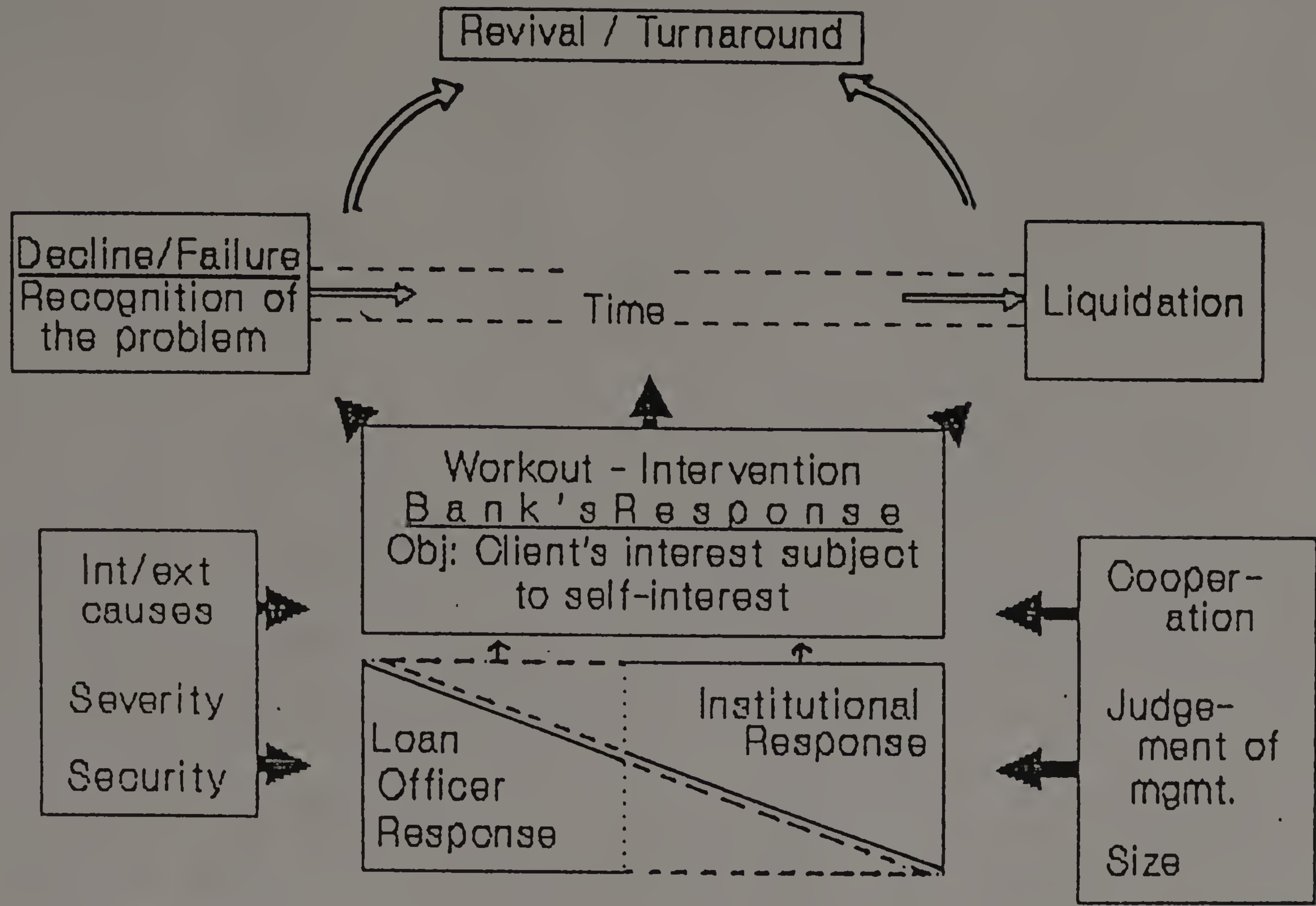

Fig.2 Role of the Bank as an External Agent

AFTERWORD

A decade ago, Dave Whetten (1980) wrote an article titled,`Organizational decline: A negtected topic in organizational science'. It was very heartening to read since I came into the doctoral program with an interest in research in decline and turnaround issues. As I reviewed the research in the field, I became even more convinced of the truth of Whetten's remarks. Our understanding about this subject is fragmented and there is very little cross-fertilization of ideas even within management; researchers have examined issues from the perspectives of strategic management, organizational behavior, accounting, etc. without borrowing insights from each other.

My personal experience as a turnaround manager, and the frequent comments I read in press reports on failing firms, convinced me of the need to examine the role of stakeholders in influencing the event in a declining firm. The literature has totally ignored these issues which, in my opinion, is a serious gap.

It was after I started attempting to narrow down my focus that I began to understand the problems of doing research in this field, which could partly explain the sparse nature of empirical studies. But it is also the peculiar mixture of a sparsely researched area combined with the challenges of doing research that has kept my interest high right through the dissertation. I faced difficulties in getting banks to participate, and am still trying to convinve them to let me talk to their problem loan clients. To seek information from a firm's perspective I have, independent of the banks, tried to track down failing firms through news reports and have approached them directly. I am yet to strike a lode! I even approached a national bankers association to provide me wth their membership list so that I could mail my questionnaire directly to randomly chosen loan officers. They declined. I kept on my research because I felt that understanding the bank's perspective is important and sacrificing randomness, matched samples, etc. was a price that was worth paying.

During times of growth and success of a firm, stakeholders prefer to sit back and identify with it, and happily accept their share of the returns with an occasional wrangle about the size of the slice. The moment an organization is in a state of decline, stakeholders including the incumbent management appear to forsake its interests while protecting their own. That is what makes turnaround so difficult; a company cannot act for itself and must depend on others who no longer seem to strongly identify with its interests.

I intend to pursue this line of inquiry on external influences on the firm during its decline-turnaround sequence as part of my research agenda for a few more years. It requires innovative research designs but there is a crying need for more and more research in this field, especially when it is of immediate use for a manager.

APPENDIX A

BANKING AND REGULATORY ENVIRONMENT

This appendix is intended to provide a brief introduction to the banking and regulatory environment in the US and Canada. As this study views business failures from the perspective of commercial banks, only those aspects of the industry as are pertinent for an understanding of the discussion elsewhere in this report will be presented. It is beyond the scope here to provide a full comparison or discussion of either the banking industry or of related regulation. Boreham (1987) provides a good survey and this chapter will essentially borrow from his and other studies.

The Banking Sector in Canada and the US

The US banking system (often called the unit banking system) operates under two charters existing side by side. There are the national banks, chartered by the federal government and supervised by the Controller of Currency, and the state banks chartered by the state governments and also supervised by them. The former are larger institutions though the latter are more numerous. Commercial banks are prohibited by the McFadden Act of 1927 from branching across state lines and the national banks are permitted to branch within the state only to the extent of the state banks.

The Canadian commercial banking system consists of eight widely held and domestically owned banks and 59 closely held and foreign owned banks. They are all chartered or incorporated by the federal government. There are no restrictions on branch expansion.

Banks in Canada are larger generally both in terms of assets and in terms of branches.

Bankruptcy Regulation in Canada and the US

In the US, the Bankruptcy Reform Act of 1978 governs the administrative, procedural, and legal requirements of bankruptcy filing in the US. (Altman, 1983, provides a thorough review of the provisions). Chapter 7 deals with involuntary liquidation and Chapter 11 with reorganization. Two major benefits of the Chapter 11 provisions are that there is no need to prove insolvency to seek the protection of the courts and there is an automatic stay of creditor action to attempt a reorganization plan.

Canadian bankruptcy is governed by the Bankruptcy Act, originally passed in 1949 and largely unchanged except for some revisions in 1966. Under this, secured creditors can move in without notice to close down a company in arrears before other creditors have a chance to find out. While there are provisions for a company to hold off creditors momentarily, the procedures are considered to be both difficult and expensive.

As compared to the US, Canada has the facility of receivership whereby a person in the nature of a trustee of the court, takes charge of the property. The debtor is not deprived of the ownership of the property but is not entitled to deal with it. A receiver can also be appointed by mutual consent of the debtor and creditor without the intervention of the court.

It is commonly believed that the laws favor the debtor in the US and the creditor in Canada. Recently, as a substitute for a Chapter 11, the Company Creditors Arrangements Act, 1933, has been revived through increased use. Originally enacted to help financially troubled railway companies with outstanding bonds get a stay of proceedings against secured and unsecured creditors, it has been recently used in courts as a form of Chapter 11.

There have been frequent demands in Canada for revisions in Bankruptcy laws to make them more favorable to the debtor and in line with the US laws. Banks have been frequently accused of being benign to large debtors and harsh towards small and medium firms and the demand has been to level the playing field. Reforms have often been proposed but none has become law as yet. With court decisions often influenced by legal thinking in the US and a lack of clarity in the laws, some progressive bankers have also begun to favor a rewriting of the laws if only to clear the confusion.

APPENDIX B

INTRODUCTORY LETTER TO BANKS

INSTITUTE FOR NORTH AMERICAN
TRADE AND ECONOMICS
UNIVERSITY OF MASSACHUSETTS
AT AMHERST

School of Management
Amherst, MA 01003
(413) 545-3253

20 Apr 1989

Dear Madam/Sir,

The Institute for North American Trade and Economics was established in 1986 to study and research economic issues of joint interest to Canada and the US and to offer objective counsel aimed at expanded benefits to them. We have cooperative research arrangements with the University of Western Ontario, Dalhousie University, and Laval University.

One of our researchers, C.Gopinath, is interested in the field of business failures and turnaround strategies. For the purpose of his dissertation research, he is undertaking a study of the role commercial banks play in Canada and the US in recognizing the failure of clients (for example, by identifying problem loans), and their subsequent responses.

In this connection, he would like to

a. Interview a few of your officers who are involved in commercial lending and the workout of problem loans, and

b. Distribute a questionnaire to a larger number of your commercial loan officers who may have problem loans in their portfolio. The response would be anonymous.

I would be grateful if you would permit Mr. Gopinath to take advantage of the experience and expertise of your bank in this venture. We would, of course, give you a summary of our findings.

Sincerely,

Elliott Carlisle

A. Elliott Carlisle
Director

APPENDIX C

INTERVIEW QUESTIONS

The following were used as a basis for conducting the interviews. They were not provided to the interviewer but retained by the researcher. Following an open-ended format, the discussion was allowed to proceed as it developed.

1. How does the bank define a problem loan?

2. What is the overall approximate percentage of troubled loans in the banks portfolio?

3. How does the bank view a problem loan? Any standard policies to deal with them? Any documents ?

4. What is the process by which a troubled loan gets identified?

5. Administratively, are the functions of loan review, workout, and asset recovery separated or combined within a department?

6. Is the loan officer involved with the loan till the end or is it taken over by another team once classified as a problem loan?

7. What is the extent of discretion given to a loan officer in classifying a problem loan? Please explain.

8. What role does the number or quantum of problem loans in a loan officers portfolio play in his/her performance evaluation?

9. In formulating its response, does the bank make a distinction between decline in the financial performance of the client (including losses), and the client's survival being threatened? If so, how is the distinction made ?

10. As soon as the bank is concerned that the client is in a state of decline, is this communicated to the client immediately (even if the funds are not at risk) or is there a time lag before the client is informed?

11. What is the nature of the client's reaction when informed? Any disagreements?

12. When the client's credit rating is reclassified downward, is he/she told about it?

13. While the bank has to be primarily concerned with protecting its funds at risk, do you also visualize the

bank's role as including other factors such as providing an early warning, helping the client overcome problems, etc. ?

14. Some of these objectives could be in conflict with each other. How do they get resolved in the process of responding to the client?

15. How do you formulate your strategy to respond to the client's problems?

16. How do you communicate to the client the actions you would like taken to turnaround? Keep track?

17. Would the size of the client make a significant difference to your response? (eg. large vs small, if the firm is not owner managed and there is a professional management in place).

18. The question of lender liability is sometimes mentioned in the press as making banks more conservative. Do you think it is a significant factor in your response?

19. Do you think there are situations where banks have to take part of the blame for a client's difficulty? (Such as improper scrutiny, over lending, etc.)

20. What are the elements of the existing Banking or other regulations which dictate or influence your current responses to problem loans? What changes would you like in these?

21. If problem loans can be looked upon as an early step in a firm's decline or failure, how do you look at the role banks play or could play in this regard?

22. Are there any other comments that you would like to make on the question of problem loan recognition, or response, or business failures in general?

APPENDIX D

QUESTIONNAIRE

INSTITUTE FOR NORTH AMERICAN
TRADE AND ECONOMICS
UNIVERSITY OF MASSACHUSETTS
AT AMHERST

School of Management
Amherst, MA 01003
(413) 545-3253

22 Nov 1989

Dear Account Manager/Loan Officer,
Bank ·

We are undertaking a study into business failures, and as a part of that, we are trying to understand the processes used by commercial loan officers in classifying and responding to problem loans. We believe the step of classifying a problem loan to be an important early indication of a failing business. We request your assistance in this study by completing the attached questionnaire. Your response will be completely anonymous and confidential; neither your's nor any client's name is required.

There are two parts to the questionnaire. Part A includes general questions about your operations.

Part B involves questions about any client whose loan is currently considered to be troubled or a problem. Kindly keep <u>a specific</u> troubled loan case in mind while you respond to the questions in this part. Preferably choose a client who has been in business for five years. I would appreciate it if you would replicate this for two problem loan cases, if possible, with each one representing a <u>different type</u> of troubled loan in <u>your</u> portfolio. (Two copies of Part B are attached.)

This survey should take only 10-15 minutes to complete. I would appreciate your completing it now and returning it in the self-addressed envelope attached. If you would like to attach any additional pages in support of your responses, you are welcome to do so.

I greatly appreciate your cooperation.

Sincerely,

C.Gopinath
Research Associate

Part A

General

1. How many years of experience do you have as a loan officer?

_____ years

2. What is the approximate number of problem loans you have handled to date?

______

3. Do you specialize in any particular industry, sector, or type of loan?

_____ No, I don't.
_____ Yes, I do. (please specify)
____
____
____

4. How are loans monitored by you on an on-going basis? (Please FILL in the appropriate number)

1 = Monthly   2 = Quarterly   3 = Annual   4 = Ad hoc
5 = Not used

_____ financial / operating reports
_____ comparing performance with plans
_____ credit reports from bureaus
_____ plant visits
_____ other (please describe)

5. How do you define a problem loan? Are there standard policies to deal with them? (You may attach any document to support your answer, if you so desire).

6. In formulating your response, do you make a distinction between decline in the financial performance of the client (including losses), and the client's survival being threatened ? If so, how is the distinction made?

7. In addition to your primary objective in protecting the bank's funds, do you visualize your role as including the following?

(Please FILL in 1 if Very Important, 2 if Somewhat Important, and 3 if Unimportant)

____ Provide an early warning to a firm of an impending crisis
____ Help a client, to the extent possible, in overcoming problems
____ (any other) ____

Part B

Client # II

Kindly keep in mind the case of ONE PARTICULAR problem loan in YOUR PORTFOLIO while answering questions in this part.

Data on the Client

1. What is the approximate age of the business?

_____ Less than 3 years _____ 4-5 years
_____ 6-10 years _____ More than 10 years

2. What is the approximate size of the firm?

$ _________ Assets $__________ Sales

3. How would the bank consider the size of the firm?

_______ small
_______ mid market
_______ large corporate

4. How long has this firm been a client of the bank?

______ years (approximate)

5. What is the nature of the firm's activity? (please check as appropriate)

_______ agriculture, forestry & fishing
_______ mining & manufacturing
_______ transportation & public utilities
_______ wholesale trade
_______ retail trade
_______ finance, insurance & real estate
_______ services
_______ (other)________________

6. Is the firm owner managed?

_____ Yes
_____ No, there is a separation between ownership and management

7. To what extent is the loan secured ?

_____ fully
_____ partly
_____ unsecured

Part B, Client # II (contd.)

8. How convertible is the collateral? (please check one)

____ easily
____ with difficulty
____ other__________________

9. Are you the sole lending bank ?

_____ Yes
_____ No, we are a lead bank in a consortium
_____ No, we are one in a consortium

10. How many successive quarters of loss have been sustained ?

Net loss ____ quarters

Cash loss ____ quarters

11. What would be the approximate percentage of accumulated losses to the net worth of the firm?

_______ %

12. In your opinion, is the present insolvency or financial embarassment of this client one which (please check one)

____ is not a major problem and could be corrected soon
____ could develop into a major crisis if ignored
____ is already threatening the survival of the firm

13. Is the loan presently being handled by you ?

____ Yes, exclusively.
____ Yes, with assistance from Loan Review/Workout dept.
____ No, it has been transferred to Workout though I am still involved.
____ It has been transferred to Workout and I am not involved.

14. Does the bank hold stock in the client firm directly or as collateral?

____ Yes, directly
____ Yes, as collateral
____ Neither directly nor as collateral

15. Are the bank's representatives on the client's board or management?

_____ Yes _______No

Part B, Client # II (contd.)

16. Is the client on the bank's board or committee?

______Board ______Committee ______Neither

Recognition of the Problem

17. What were the main cues used to IDENTIFY THIS client as a problem loan? (Please circle the most appropriate response).

	VERY IMPORTANT	IMPORTANT	SOMEWHAT IMPORTANT	OF LITTLE IMPORTANCE	UNIMPORTANT
Analysis of financial ratios	1	2	3	4	5
Deviation of performance from plan	1	2	3	4	5
Declining sales trend	1	2	3	4	5
Declining profits trend	1	2	3	4	5
Inadequate cash flow	1	2	3	4	5
Deteriorating receivables	1	2	3	4	5
Slow inventory turnover	1	2	3	4	5
Extended trade payables	1	2	3	4	5
Change in accountants	1	2	3	4	5
Change in key stockholders and executives	1	2	3	4	5
Credit inquiries from trade	1	2	3	4	5
Problems of the industry	1	2	3	4	5
Personal factors (death, divorce,etc)	1	2	3	4	5
Delayed submission of financial statements	1	2	3	4	5
Reluctance to share information with the bank	1	2	3	4	5
Occurrence of Overdraft's	1	2	3	4	5
Delinquent or slow loan payments	1	2	3	4	5
Qualification in the audit report	1	2	3	4	5
Other (please specify)					
....	1	2	3	4	5
....	1	2	3	4	5

Part B, Client # II (contd.)

18. How long after a problem was identified was the firm classified as a "problem loan"?

    _______ weeks/months
    (please check time unit which is applicable)

19. How long after you identified the problem was the client informed of the bank's concern?

    _______ weeks/months
    (please check time unit which is applicable)

20. When informed, did the client accept the bank's judgement that the firm's performance was a major cause for concern?

    ____ Yes, they did.
    ____ No, they did not.
    ____ The client recognized the problem and voluntarily notified the bank

21. Which one of the following statements would best describe the firm when it was classified as a problem loan. (please check)

    ___ The problems were of a temporary nature which could be tackled
    ___ The problems were serious causing a decline in financial performance but not critical
    ___ The firm was in a crisis which threatened its survival

22. Did the bank have to "shock" the client into recognizing the situation as a crisis (e.g. additional credit being made conditional to changes, etc.)

    ____ Yes ____No

23. This loan could have become troubled due to a variety of causes. If you were to allot 100% among three broad categories as contributing to the problem loan, how would you distribute it in this case ?

____ % Firm (Bad management of operations, poor strategy/planning, incompetence, etc.)

____ % Bank (High interest rate, ill conceived terms, overlending, anxiety for income for the bank, poor review and audit, competition with other banks, etc.)

____ % Environment (Factors beyond firm or bank's control such as recession, disaster, government policies, etc.)

100 %

Part B, Client # II (contd.)

24. What, in your opinion, were the CAUSES FOR THE DECLINE in financial performance of the firm?

(Please circle the most appropriate response).

	VERY IMPORTANT	IMPORTANT	SOMEWHAT IMPORTANT	OF LITTLE IMPORTANCE	UNIMPORTANT
Rapid growth / over expansion	1	2	3	4	5
Inadequate capacity	1	2	3	4	5
Poor location	1	2	3	4	5
Heavy debt	1	2	3	4	5
Decreased profit margins of the products	1	2	3	4	5
Increased competition in the industry	1	2	3	4	5
High interest rates	1	2	3	4	5
Declining market size of the industry	1	2	3	4	5
Inadequate sales	1	2	3	4	5
High overheads	1	2	3	4	5
Heavy operating expenses	1	2	3	4	5
Receivables difficulties	1	2	3	4	5
Incompetent management	1	2	3	4	5
Unbalanced experience in the top team	1	2	3	4	5
One-man rule	1	2	3	4	5
Competitively weak	1	2	3	4	5
Neglect (family/marital problems, health etc)	1	2	3	4	5
Fraud	1	2	3	4	5
Disaster (fire, burglary)	1	2	3	4	5
Other (please specify)					
....	1	2	3	4	5
....	1	2	3	4	5
....	1	2	3	4	5

Part B, Client # II (contd.)

Response

25. What are the considerations influencing the RESPONSE OF THE BANK in this case?

(Please circle the most appropriate response.)

	VERY IMPORTANT	IMPORTANT	SOMEWHAT IMPORTANT	OF LITTLE IMPORTANCE	UNIMPORTANT
Public image	1	2	3	4	5
Borrower's positive attitude towards the debt	1	2	3	4	5
Borrower's negative attitude towards the debt	1	2	3	4	5
Judgement on the client's ability to turnaround and repay	1	2	3	4	5
Collateral value to loan amount	1	2	3	4	5
Value of the client to the bank as a customer	1	2	3	4	5
Cost of collection of the loan	1	2	3	4	5
Cost and effort in rehabilitation of the borrower	1	2	3	4	5
Which method will net the bank the greatest return on funds extended	1	2	3	4	5
Effect of the bank's action on the community	1	2	3	4	5
Firm's performance in relation to the industry	1	2	3	4	5
Lender liability issues	1	2	3	4	5
Protection of the bank's funds at risk	1	2	3	4	5
Attitude of the other creditors	1	2	3	4	5
Others (please specify)					
....	1	2	3	4	5
....	1	2	3	4	5

Part B, Client # II (contd.)

26. Which of the following types of INTERVENTION are under consideration or have been implemented? (Please circle the most appropriate response).

	UNDER ACTIVE CONSIDERATION/ IMPLEMENTATION	LIKELY TO BE CONSIDERED OR RESORTED TO	NEUTRAL-MAY OR MAY NOT BE CONSIDERED	NOT LIKELY, OF LOW IMPORTANCE	WILL NOT BE CONSIDERED
Seeking additional collateral for existing loans	1	2	3	4	5
Seeking guarantees in addition to existing collateral	1	2	3	4	5
Granting additional loans with collateral/guarantees	1	2	3	4	5
Time extension of the due date of the debt	1	2	3	4	5
Partial forgiveness of the debt	1	2	3	4	5
Sale of loan to another bank	1	2	3	4	5
Terminate the loan allowing client time to find another bank	1	2	3	4	5
Recommend additional capitalization	1	2	3	4	5
Recommend downsizing business/asset divestment	1	2	3	4	5
Recommend merger/ acquisition by another	1	2	3	4	5
Recommend change of top management (CEO)	1	2	3	4	5
Recommend change of key personnel (GM, Accountant, etc.)	1	2	3	4	5
Recommend change of strategies	1	2	3	4	5
Recommend use of consultants	1	2	3	4	5
Suggest improvement in systems & controls	1	2	3	4	5
Suggest improvements in operations/ cost reductions	1	2	3	4	5
Recall of loan	1	2	3	4	5
Proceed to recover through State courts	1	2	3	4	5
Proceed to recover through Federal Bankruptcy court	1	2	3	4	5
Settle out of court with loss of interest	1	2	3	4	5

Part B, Client # II (contd.)

	UNDER ACTIVE CONSIDERATION/ IMPLEMENTATION	LIKELY TO BE CONSIDERED OR RESORTED TO	NEUTRAL-MAY OR MAY NOT BE CONSIDERED	NOT LIKELY, OF LOW IMPORTANCE	WILL NOT BE CONSIDERED
Settle out of court with loss of principal and interest	1	2	3	4	5
Exchange of debt for an equity position	1	2	3	4	5
Other (please specify)					
....	1	2	3	4	5
....	1	2	3	4	5

General

Are there any other comments you would like to make about the issue of problem loans, firms facing a failure, or this questionnaire?

APPENDIX E

REGULATORY GUIDELINES ON PROBLEM LOANS

Extracts from regulatory guidelines in the US and Canada on the handling of problem loans are given below. These are used by the examiners of the respective banking systems to supervise the status of problem loans in the banks from the point of view of accounting for them and providing for reserves. They serve as the basis on which member banks establish their rating systems which usually are more elaborate and in greater detail.

US

(Extracts from "Comptroller's Handbook for National Bank Examiners", August 1985)

Careful analysis, coupled with discussions with officers and directors, enables the examiner to pinpoint loans which need strengthening and careful management if they are to be collected. Such assets are assigned a quality rating based on the examiner's best judgement concerning the degree of risk and the likelihood of orderly liquidation. In determining what credits are to be criticized, the examiner must utilize mature credit judgment. No formula covers all the various types of loans made by banks.

Even a loan that is current and supported by underlying collateral or contingent obligors may be criticized.. Conversely, not all delinquent loans should be classified. The original source of repayment and the borrower's ability to utilize it should be a determining factor in criticizing a loan....Criticized assets are categorized into four following classifications:

1. Other Assets Especially Mentioned

Assets in this category are currently protected but are potentially weak...(These) have potential weaknesses which may, if not checked or corrected, weaken the asset or inadequately protect the bank's credit position at some future date. ...An adverse trend in the obligor's operations or an imbalanced position in the balance sheet which has not reached a point where the liquidation is jeopardized, may best be handled by this classification.

2. Substandard Assets

A substandard asset is inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any...They are characterized by the distinct possibility that the bank will sustain some loss if the deficiencies are not corrected.

3. Doubtful Assets

An asset classified doubtful has all the weaknesses inherent in one classified substandard with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable.

4. Loss Assets

Assets classified loss are considered uncollectible and of such little value that their continuance as bankable assets is not warranted.

Canada

(Extracts from the "Guidelines to Banks", July 1986, issued by the Office of the Superintendent of Financial Institutions).

Non-performing loans comprise of non-accrual and renegotiated reduced rate loans...Non-accrual loans are defined as loans on which interest is not being accrued due to the existence of reasonable doubt as to the ultimate collectibility of principal or interest. Loans where interest is contractually past due 90 days are automatically to be placed on a non-accrual basis, unless senior credit management determines that there is no reasonable doubt as to the ultimate collectibility of principal or interest.

The override clause in the non-accrual loan definition is intended to provide management of banks with a degree of flexibility where the borrower may be more than 90 days in arrears on interest payments, but where management expects the arrearage will be eliminated in the normal course of business; for instance where the loan is well secured. Renegotiated reduced rate loans are defined as loans where terms have been modified to provide for a reduction in the interest rate due to the weakened financial condition of the borrower.

(The risk categories are:)

a. Satisfactory

Acceptable Risk

b. Especially Mentioned

An asset or contingent risk which, although considered collectible on the basis of the security presently held, (including guarantees and letters of comfort/awareness provided adequate financial data is held in support thereof.) has apparent weaknesses and/or undesirable features to which attention is directed. These would include under-capitalization, continuing operating losses and/or other undesirable features.

c. Below Standard

A substandard asset or contingent risk not adequately supported by security values and/or repayment capacity and/or carrying capacity. There are well defined weaknesses which could jeopardize ultimate collection of all principal and interest. Loans in this category may be designated "accrual" or "non-accrual" depending on the current status of interest payments and the value of the underlying security.

d. Loss

An asset of contingent risk where a partial or full write-off is the likely outcome. These assets/risks should invariably be designated as "non-accrual" and a full or partial appropriation established based on an analysis of the security and repayment source(s).

APPENDIX F

EXTRACTS FROM RATING SYSTEMS

This appendix provides extracts from the rating systems of three banks. They are not complete and are meant to illustrate the nature and detail of the topics covered relevant to the parts referred to in the main body the report.

BANK A (Canada)

The rating scale is comprised of ten categories offering adequate flexibility to recognize a wide range of potential risk classifications.

In determining a final risk rating for each borrower, the account officer is asked to assess the borrower's overall performance by considering the following seven factors:

a. financial performance
b. management
c. industry status
d. security position
e. terms of support
f. account activity
g. competitor actions

While the process involves an indepth assessment of the seven factors identified, the borrower's financial condition and to a lesser degree the bank's security coverage will continue to weigh most heavily in final risk rating determinations. Classification criteria reflects the importance placed on these factors and are formally introduced as trip-wires.

Category Descriptions

3b: Possible problem loan.

Principal &/or interest payments may be in arrears 15 or more days. Material adverse change in financial performance or security or if, in combination, any three factors are less than acceptable.

Discussions with or direct involvement by Workout department. Intensive customer negotiations, etc.

4: Actual problem loan.

Principal &/or interest payment 30 or more days in arrears. Agreement/decision reached to capitalize interest, make specific provision, etc. Material adverse change in financial performance or security or if in combination any four factors are less than acceptable.

Mandatory referral to workout department, review by counsel, etc.

5: Serious problem loan.

Principal &/or interest payments 90 days or more in arrears. Financial performance precludes the meeting of principal & interest.

Mandatory referral to workout department, extensive involvement of external professionals etc.

6: Bankruptcy, Asset liquidation.

Filing court approval for re-organization, court approves or considers plan, etc.

Decision on reserves, write-offs, aggressive monitoring, etc.

<u>Description of Assessment Factor - Management:</u>

Areas to be assessed include: Quality, competence, depth, and stability.

Many indications of pending problems can be evident before management's performance results in non-performing assets. Examples include:

- Lack of clear understanding of key leverage points in their business(es).
- Inability to identify or implement corrective action.
- Financial set-backs not satisfactorily explained.
- Over-reliance on a single product/ customer/ supplier/ market.
- Business plan presentations, heavy on optimism, with lack of thought to a worst case scenario.
- etc.

<u>BANK B (Canada)</u>

This bank has 10 risk rating categories. Rating 5 and below would be problem loans.

Rating Description Summary:

5: Unacceptable risk- Watch List.

Financial position under capitalized, unbalanced debt, reporting losses or less than satisfactory profits, management weak. Insufficient security. Principal and/or interest current to 89 days delinquent, accruing.

6: Non-performing loan, accrual.

Weak financial condition, classified as renegotiated reduced rate, principal and/or interest current to 89 days delinquent, and accruing.

Worksheet for Classification:

The worksheets for classification of risk cover four areas: Management(13), money(42), materials(16), and markets(12). The numbers within parentheses indicate the number of `considerations' or items under each. Samples are as below:

Management:
- -Possibility of owners being unable to inject additional equity when needed.
- -possibility of change of control.
- -possibility of adverse effect from inadequate management for operations planned.
- -possibility of adverse effect from lack of adequate organization structure, planning, policies, etc.

Money:
- -reliability of forecast financial information.
- -clarity of information on borrowers consolidated statements.
- -condition of current debt.
- -trend of net profit.
- -historical performance.

Materials:
- -length of manufacturing period.
- -condition of inventory.
- -adequacy of fixed assets.

Markets:
- -stability of demand.
- -vulnerability to competition.
- -vulnerability to technological change.

BANK C (US)

This bank has 9 risk rating categories, with 5 and below being watch/problem loans.

Category Descriptions:

5: Borderline (temporary).

While financial condition remains satisfactory, events are occurring or will occur in the very near future which will cause the customer's risk rating to either remain Satisfactory (rating 4) or move to Special Mention.

6: Special Mention.

Weakened financial condition arising from negative trends, adverse events, and/or concerns with management which, if not corrected, may have a material impact on the servicing of the bank's exposure.

7: Substandard.

Unsatisfactory financial condition creating a distinct possibility of business failure if deficiencies are not corrected.

8: Doubtful.

Weak financial condition where full repayment of bank's exposure is doubtful. A partial loss of principal is likely.

9: Loss.

Any remaining principal is considered a total loss. Exposure, net of charge-off must be zero.

BIBLIOGRAPHY

Abdel-Khalek, A. Rashad & El-Sheshai, Kamal M. 1980. Information choice and utilization in an experiment on default prediction. _Journal of Accounting Research_, 18(2): 325-342.

Altman, E.I., & La Fleur, James K. 1981. Managing a return to financial health. _Journal of Business Strategy_, 2(1): 31-38.

Altman, E.I. 1983. _Corporate financial distress: A complete guide to predicting, avoiding and dealing with bankruptcy_. NY: Wiley.

Ang, James S. & Chua, Jess H. 1980. Coalitions, the me-first rule, and the liquidation decision. _Bell Journal of Economics_, 11: 355-359.

Argenti, John. 1976a. _Corporate collapse_. UK: McGraw Hill.

Argenti, John. 1976b. Corporate planning and corporate collapse. _Long Range Planning_, 9: 12-17.

Bank Facts. 1987. Toronto: Canadian Bankers Association.

Bankruptcy and insolvency: Report of the study committee on bankruptcy and insolvency legislation. 1970. Ottawa: Information Canada.

Bauch Jr., Frederick L. 1987. Managing problem loans to avoid lender liability. _Journal of Commercial Bank Lending_, Jan. 25-31.

Bibeault, Donald B. 1981. _Corporate turnaround: How managers turn losers into winners_. NY: McGraw Hill.

Billings, Robert S., Milburn, Thomas W., and Schaalman, Mary Lou. 1980. A model of crisis perception: A theoretical and empirical analysis. _Administrative Sciences Quarterly_, 25: 300-316.

Boreham, Gordon F. 1987a. The contemporary banking scenes. _Canadian Banker_, May-June.

Boreham, Gordon F. 1987b. No natural separation. _Canadian Banker_, July-Aug.

Boulding, Kenneth E. 1975. The management of decline. _Change_, 7(5): 8-9,64.

Bradlow, David A. 1986. Early detection of problem loans. _Journal of Commercial Bank Lending_, 68: 48-56.

Bruno, Albert V., Leidecker, Joel K. & Harder, Joseph W. 1987. Why firms fail. Business Horizons, 50-58. Mar-Apr.

Bulow, Jeremy I. & Shoven, John B. 1978. The bankruptcy decision. Bell Journal of Economics, 9(2): 437-456.

Cameron, Kim S., Whetten, David A. & Kim, Myung V. 1987. Organizational dysfunctions of decline. Academy of Management Journal, 30(1): 126-138.

Cameron, Kim S., Kim, Myung V., & Whetten, David A. 1987. Organizational effects of decline and turbulence. Administrative Sciences Quarterly, 32: 222-240.

Cameron, Kim S., Sutton, Robert I., & Whetten, David A. 1988. (Eds.) Readings in organizational decline. Ma: Ballinger.

Cannon, Louise L. 1987. Dealing with non-performing loans- A banker's view. Paper presented at the Conference on Strategies for non-performing loans, 31 Mar, Insight Educational Services, Ontario.

Casey, Cornelius J. 1980. The usefulness of accounting ratios for subjects' predictions of corporate failure: Replication and extensions. Journal of Accounting Research, 18(2): 603-613.

Casey, Cornelius J. and Bartczak, Norman J. 1984. Cash flow- its not the bottom line, Harvard Business Review. 62(4): 61-66.

Casey, Cornelius J., McGee, Victor E. & Stickney, Clyde P. 1986. Discriminating between reorganized and liquidated firms in bankruptcy. The Accounting Review, 61(2): 249-262.

Chaganti, Rajeswara Rao, Mahajan, Vijay, & Sharma, Subhash. 1985. Corporate board size, composition and corporate failures in retailing industry. Journal of Management Studies, 22(4): 400-417.

Commission on the Bankruptcy Laws of the US, Report of. 1973. HR Doc. No: 137, 93d Cong, 1st Session.

Committee on Small Business. 1982. Current business failure epidemic. Hearing before the Subcommittee on General Oversight, US Congress, House of Representatives, 23 June.

Cooper, Arnold C., Woo, C., & Dunkelberg, W. 1986. Survival and failure: A longitudinal study. In B.Kirchoff, J.Timmons, & K.Vesper (Eds.) Frontiers of entrepreneurship research. Boston: Babson College.

Cowan, David A. 1986. Developing a process model of problem recognition. Academy of Management Review, 11(4): 763-776.

D'Aveni, Richard A. 1988. A longitudinal study of strategic and managerial characteristics associated with post-decline lingering and paralysis. Paper presented at the annual meeting of the Academy of Management Annual Meeting, Anaheim, California.

Denzin, N.K. 1978. The research act. (2ed.) New York: McGraw Hill.

Dolan, Patrick F. 1983. A four phased rescue plan for today's troubled companies. Journal of Business Strategy, 4(1): 22-30.

Dun & Bradstreet. 1981. Business failure record. NY: Dun & Bradstreet.

Dunbar, Roger L.M., & Goldberg, Walter H. 1978. Crisis development and strategic response in European corporations. In Smart, C.F., & Stanbury, W.T. (Eds.) Studies in crisis management. 139-149. Toronto: Institute for Research on Public Policy.

Fink, Stephen L., Beak, Joel, & Taddeo, Kenneth. 1971. Organizational crisis and change. Journal of Applied Behavioral Science, 7(1): 15-27.

Finkin, Eugene F. 1983. Company turnaround. Journal of Business Strategy, 14-24.

Finkin, Eugene F. 1987. Successful corporate turnarounds. NY: Quorum Books.

Francis, Diane. 1988. Keeping the creditors at bay. Macleans, Mar 14, 101: 11.

Fredland, J. Eric. 1973. The business bankrupts. Commission on bankruptcy laws, US Congress.

Gilad B., Kaish, S. & Loeb, P.D. 1985. A theory of surprise and business failure. Journal of Behavioral Economics, 14: 35-55.

Giroux, G.A. & Wiggins, C.E. 1984. An events approach to corporate bankruptcy. Journal of Bank Research, 15(3); 179-187.

Gopinath, C. 1989. The critical phase in a business turnaround. Proceedings of the Eastern Academy of Management, Portland, Maine.

Gubernick, Lisa. 1986. Lender beware. Forbes, June 30, 137: 104-106.

Hambrick, D.C. & Schecter, S. 1983. Turnaround strategies for mature industrial product business units. Academy of Management Journal, 26: 231-248.

Hambrick, Donald C. & D'Aveni, Richard. 1988. Large corporate failures as downward spirals. Administrative Sciences Quarterly, 33(1): 1-23.

Hannan, Michael T. & Freeman, John H. 1977. The population ecology of organizations. American Journal of Sociology, 82: 929-964.

Harrigan, K. R. 1980. Strategies for declining businesses. MA: Lexington Books.

Hatch, James E. & Wynant, Larry. 1986. Canadian commercial lending. Toronto: Methuen.

Hedberg, Bo L.T., Nystrom, Paul, & Starbuck, William. 1976. Camping on seesaws: Prescriptions for a self-designing organization. Administration Sciences Quarterly, 21: 41-65.

Hermann, Charles F. 1963. Some consequences of crisis which limit the viability of organizations, Administrative Sciences Quarterly, 8: 61-82.

Hofer, C.W. 1980. Turnaround strategies. Journal of Business Strategy, 1(1): 19-31.

Hoffman, Richard C. 1989. Strategies for corporate turnarounds: what do we know about them? Journal of General Management, 14(3): 26-66.

Holsti, Ole R. 1978. Limitations of cognitive abilities in the face of crisis. In Smart, C.F. & Stanbury, W.T. (Eds.) Studies in crisis management. Toronto: Butterworth.

Jick, Todd. 1979. Mixing qualitative and quantitative methods- Triangulation in action. Administrative Sciences Quarterly, 24: 602-611.

Keasey, K. & Watson, R. 1987. Non-financial symptoms and the prediction of small company failure: A test of Argenti's hypothesis. Journal of Business Finance and Accounting, 14(3) 335-354.

Khandwalla, Pradip N. 1983. Turnaround management of mismanaged complex organizations. International Studies of Management & Organization, 13(4): 5-41.

Lawrence, Paul & Dyer, Davis. 1983. Renewing american industry. NY: The Free Press.

Levine, Charles H. 1978. Organizational decline and cut-back management. Public Administration Review, 38: 316-325.

Libby, Robert. 1975. The use of simulated decision makers in information evaluation. The Accounting Review, 50: 475-489.

LoPucki, Lynn M. 1983. The debtor in full control- Systems failure under Chapter 11 of the Bankruptcy Code. American Bankruptcy Law Journal, 57(1):99-127, 247-273.

Lorange, Peter & Nelson, Robert T. 1987. How to recognize- and avoid-Organizational decline. Sloan Management Review, 28: 41-48.

Magaziner, Ira C. & Reich, Robert B. 1982. Minding America's business. NY: Vintage Books.

Mamis, Robert A. 1988. How to renegotiate your loan. Inc, November: 161-164.

Marshall, Catherine & Rossman, Gretchen. 1988. Designing Qualitative Research. Ca:Sage.

McAuliffe, Robert L. 1987. Responsibilities of the prepetition creditor. Credit & Financial Management, 89: 14-17.

McKelvey, Bill & Aldrich, Howard. 1983. Population, natural selection, and applied organizational science. Administrative Sciences Quarterly, 28: 101-128.

McLaughlin, Mark. 1986. Lender liability: Lawsuits contend banks responsible when businesses fail. New England Business, 8(15): 61-62.

Miles, Mathew B. & Huberman, A. Michael. 1984. Qualitative data analysis: A sourcebook of new methods. Beverley Hills: Sage.

Miller, Danny & Friesen, Peter H. 1977. Strategy making in context: Ten empirical archetypes. Journal of Management Studies, , 253-280.

Miller, Danny. 1977. Common syndromes of business failures. Business Horizons, 43-53.

Nelson, Philip B. 1981. Corporations in crisis. NY: Praeger.

Nemer, Gary. 1982. Analysis of problem loan alternatives for secured lenders. Journal of Commercial Bank Lending, 65(2): 38-52.

O'Neill, Hugh M. 1980. Turnaround strategies in the commercial banking industry. Unpublished doctoral dissertation, University of Massachusetts, Amherst.

O'Neill, Hugh M. 1982. Turnaround strategies: An empirical search for hypotheses. Proceedings of the annual meeting of the Eastern Academy of Management Proceedings, Boston, Ma.

O'Neill, Hugh M. 1986. Turnaround and recovery: What strategy do you need? Long Range Planning, 19(1): 80-88.

Penrose, Edith T. 1959. The theory of the growth of the firm. Oxford: Blackwell.

Perrow, C. 1986. Complex organizations: A critical essay. (3rd. ed.). NY: Random House.

Pfeffer, J. & Salancik, G.R. 1978. The external control of organizations: A reseource dependence perspective. NY: Harper & Row.

Piore, Michael J. & Sabel, Charles F. 1984. The second industrial divide. NY: Basic Books.

Platt, Harlan D. 1985. Why companies fail: Strategies for detecting, avoiding and profiting from bankruptcy. Ma: Lexington.

Ramanujam, Vasudevan. 1984. An empirical examination of contextual influences on corporate turnaround. Paper presented at the annual meeting of the Academy of Management, Boston, Ma.

Reed, Edward N. 1963. Commercial bank management. NY: Harper & Row.

Reed, Edward W., Cotter, Richard V., Gill, Edward K., & Smith, Richard K. 1984. Commercial banking. NJ: Prentice Hall.

Richards, Max D. 1973. An exploratory study of strategic failure. Proceedings of the annual meeting of the Academy of Management, Boston, Ma.

Ross, Joel & Kami, Michael, J. 1973. Corporate management in crisis : Why the mighty fall. NJ: Princeton Hall.

Rossman, Gretchen B. & Wilson, Bruce L. 1985. Combining quantitative and qualitative methods in a single large scale evaluation study. Evaluation Review, 9(5): 627-643.

Schendel, Dan & Patton, G.R. 1976. Corporate stagnation and turnaround. Journal of Economics & Business, 28: 236-241.

Schendel, Dan, Patton,G.R. & Riggs, James. 1976. Corporate turnaround strategies: A study of profit decline and recovery, Journal of General Management, 3(3): 3-11.

Scherer, F.M. 1980. Industrial market structure and economic performance. (2nd. ed.). Chicago: Rand McNally.

Schwartz, Kenneth B. & Menon, K.G. 1985. Executive succession in failing firms. Academy of Management Journal, 28(3):680-686.

Scott, William G. 1976. The management of decline. The Conference Board Record, June: 56-59.

Sharma, Subhash & Mahajan, Vijay. 1980. Early warning indicators of business failure. Journal of Marketing, 44: 80-89.

Slatter, Stuart. 1984. Corporate recovery: Successful turnaround strategies and their implementation. London:Penguin.

Smart, C.F., Thompson, W.A. & Vertinsky, I. 1978. Diagnosing corporate effectiveness and susceptibility to crisis. In Smart, C.F. & Stanbury, W.T. (Eds.). Studies in crisis management. Toronto: Institute for Research on Public Policy.

Starbuck, William H., Greve, Arent & Hedberg, Bo L. T. 1978. Responding to crisis. In Smart, C.F. & Stanbury, W.T. (Eds.). Studies in crisis management. Toronto: Institute for Research on Public Policy.

Staw, Barry M., Sandelands, Lance E. & Dutton, Jane E. 1981. Threat-Rigidity effects in organizational behaviour: A multilevel analysis. Administrative Science Quarterly, 26: 501-524.

Sutton, Robert I., Eisenhardt, Kathleen M. & Jucker, James V. 1986. Managing organizational decline: Lessons from Atari. Organization Dynamics, 14: 17-30.

Thietart, R.A. & Vivas, R. 1984. An empirical investigation of success strategies for businesses along the product life cycle. Management Science, 30(12): 1405-1423.

Turner, Barry A. 1988. Connoisseurship in the study of organizational cultures. In Bryman, Alan. (Ed.). Doing research in organizations, 108-122. London & NY: Routledge.

Turner, Barry A. 1976. The organizational and inter-organizational development of disasters. Administrative Sciences Quarterly, 21: 378-397.

Weitzel, William & Jonsson, Ellen. 1989. Decline in organizations: A literature integration and extension. Administrative Sciences Quarterly, 34(1): 91-109.

Whetten, D.A. 1980a. Organizational decline: A neglected topic in organizational science. Academy of Management Review, 5(4): 577-588.

Whetten, D. A. 1980b. Sources, responses, and effects of organizational decline. In Kimberley, John R. & Miles, Robert H. (Eds.). The organizational life cycle, 342-374. Ca: Jossey Bass.

Whetten, D. A. 1987. Organizational growth and decline processes. Annual Review of Sociology, 13: 335-358.

Williams, Charles M. 1984. When the mighty stumble. Harvard Business Review, 126-139.

Zammuto, Raymond F. & Cameron, Kim S. 1985. Environmental decline and organizational response. In L.L. Cummings & Barry M. Staw (Eds.). Research in organizational behaviour, 7: 223-262. Ct:Jai Press.

Zeller, Thomas L. & Mendelow, Aubrey L. 1989. The use of cash flow from operations as a measure of strategic performance. Paper presented at the annual meeting of the Academy of Management, Washington, D.C.

Zimmerman, Frederick M. 1987. A longitudinal study of significant business turnarounds in the automotive and agricultural equipment industries. Unpublished doctoral dissertation, University of Minnesota.